The Economic and Budget Outlook: An Update

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THE ECONOMIC AND BUDGET OUTLOOK:
AN UPDATE

The Congress of the United States
Congressional Budget Office

PREFACE

The Economic and Budget Outlook: An Update is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

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CHAPTER I. SUMMARY AND INTRODUCTION

The purpose of this report is to update the economic and budget projections of the Congressional Budget Office (CBO) to reflect economic developments of the last six months and recent Congressional actions.

Last winter CBO projected an immediate resumption of economic growth and further gradual improvement in inflation. Despite the depth of the recession, the recovery was expected to be weaker than the average cyclical recovery, largely because of persistently high interest rates. As it turned out, interest rates were higher than anticipated while both unemployment and inflation abated more than expected. Although the economy was even weaker than projected in the first months of the recovery, it scored very large gains in employment, sales, and output in the second quarter. Given the momentum now building in the economy, CBO's updated forecast shows significantly more economic growth during the first year of recovery than anticipated last February. Nevertheless, this recovery looks to be quite precarious, largely because of high interest rates and uncertainty surrounding the future course of monetary and fiscal policy.

The First Concurrent Resolution on the Budget for Fiscal Year 1984 calls for policies that would slow the growth of spending, raise additional taxes, and reduce the growth of structural deficits. According to CBO's budget projections, the resolution's policies in the context of the stronger recovery now in prospect would result in declining deficits in the 1984-1986 period—a turnaround from CBO's projection of rising deficits based on the policies and forecasts of last February. Nevertheless, budget deficits would still remain very high by historical standards, partly because those policies would have little effect on the deficit until after 1984. In fact, the structural element in the deficit would not begin to decline until 1986, suggesting continued pressure on interest rates with attendant adverse effects on interest-sensitive sectors of the economy.

The CBO projections assume that the budget resolution will be implemented, but passage of the budget resolution is only the first step in enacting and implementing specific measures to reduce deficits. Unless Congress and the Administration act to carry out these or similar policies, the outlook is for budget deficits on the order of $200 billion for years to come.

Deficits will also remain very high if economic growth proves weaker than anticipated. While underlying demand is strong, the recovery may not be sustained if inflation and interest rates rise to high levels once again. Projecting inflation and interest rates is difficult especially in view of the uncertainty surrounding the budget, monetary policy, and the foreign debt situation in developing countries. And even small differences in estimated inflation and interest rates can have sizable effects on projections of outlays, revenues, and the deficit.

Many private forecasts are based on the assumption that the deficit-reduction measures of the budget resolution will not be enacted. Such forecasts generally show higher deficits, higher interest rates, and less strength in interest-sensitive sectors than CBO's projection. In addition, money growth has been so rapid that some economists expect Federal Reserve policy to become considerably more restrictive in the months ahead in order to prevent the possible return of high rates of inflation. CBO's economic projection does not presume a substantial further rise in rates from the levels that prevailed in early August.

RECENT ECONOMIC DEVELOPMENTS

The country is now well on the way to recovery from its deepest postwar recession (see Table 1). Just as the downturn was precipitated by tight credit conditions, so an easing of monetary policy, beginning a year ago, together with an expansive fiscal policy brought recovery. The impact of these policies was felt in a strengthening of household demands, particularly for housing and consumer durables, and an end to the cutback in production designed to reduce inventories. Consumer outlays outran growth in disposable income in the first half of this year; by the second quarter the personal savings rate had declined to its lowest level in over 30 years.

Although the recovery began last December, GNP growth was not strong in the first quarter of the year, but consumer spending increased sharply in the second quarter, contributing to an 8.7 percent annual rate increase in real GNP. 1/ The gains in economic activity were large and widespread—except for net exports, which declined in the first half of the year. Labor markets improved dramatically, although unemployment still remains very high. In the March-July period, nonfarm payroll employment increased by about 1½ million workers and the civilian unemployment rate declined to 9.5 percent in July from its record high of 10.8 percent last December.

1/ The National Bureau of Economic Research has dated November 1982 as the trough of the recession. Thus, the first quarter of recovery was Q1 of 1983.

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

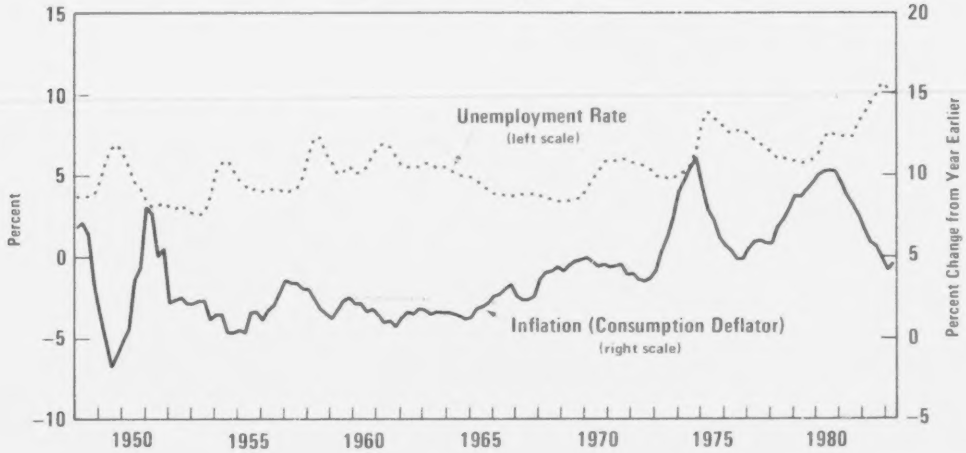
			1982				1983	
	1980	1981	Q1	Q2	Q3	Q4	Q1	Q2
Real GNP	-0.3	2.6	-5.5	1.0	-1.0	-1.3	2.6	8.7
Final sales	0.5	1.8	-1.3	-0.8	-1.5	4.5	0.6	5.5
Consumption	0.5	2.7	2.4	3.1	0.9	3.6	2.9	10.0
Business fixed investment	-2.4	5.2	-5.9	-14.3	-8.8	-6.6	-1.5	4.6
Residential investment	-20.4	-5.2	-28.5	17.9	-13.0	53.2	57.3	61.1
Government purchases	2.2	0.8	-0.2	-5.0	9.4	10.6	-8.8	-0.9
Inventory Change (billions of 1972 dollars)	-4.4	8.5	-10.2	-3.4	-1.3	-22.7	-15.4	-4.5
Net Exports (billions of 1972 dollars)	50.3	43.0	35.2	33.4	24.0	23.0	20.5	10.2
Industrial Production	-3.6	2.6	-11.7	-6.6	-3.4	-8.1	9.9	17.8
Payroll Employment (millions)	90.4	91.2	90.3	89.9	89.3	88.8	88.8	89.4
Unemployment Rate (percent)	7.2	7.6	8.8	9.4	10.0	10.7	10.4	10.1
Inflation Rate								
CPI-U	13.5	10.3	3.0	5.3	7.8	2.0	-0.4	4.2
GNP deflator (fixed weight)	9.8	9.5	5.3	4.7	5.9	4.7	3.4	5.2
Interest Rates (percent)								
Treasury Bill Rate	11.4	14.0	12.8	12.4	9.3	7.9	8.1	8.4
Corporate AAA Bond Rate	11.9	14.2	15.0	14.5	13.8	11.9	11.8	11.6

The recession brought about a rapid decline in inflation—from about 9.6 percent in 1981 to a 5.3 percent annual rate in the last half of 1982, as measured by the fixed-weight GNP deflator (see Figure 1). Despite the recovery, inflation continued to moderate in the first half of this year to a 4.3 percent rate because of slack in the economy and weak commodity prices, particularly for petroleum products and food. Although commodity prices account for much of the improvement in inflation this year, measures of inflation that exclude volatile food and fuel prices also indicate that inflationary momentum continued to decline. Unusually large reductions in the rate of wage increases have contributed significantly to the decline in underlying inflation.

Many economic indicators suggest that consumer demands will grow rapidly in the months ahead. Real earnings, employment, and consumer balance sheets have improved and consumer confidence has risen to the

Figure 1.

Postwar Inflation and Unemployment



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics.

highest level in more than a decade. The sharp decline in the ratio of real manufacturing and trade inventories to sales—from 1.76 in the fourth quarter of 1982 to 1.60 in May of this year—suggests production will pick up with attendant gains in employment and incomes. As consumer confidence rises with incomes—enhanced by the July tax cut—consumer spending should continue to strengthen during the second half of this year. Current indicators of investment spending, which are usually weak in the early stages of recovery, suggest a rebound later this year and in 1984. Indicators of defense spending are strong, suggesting this sector will continue to make an important contribution to growth in the year ahead.

On the other hand, growth in residential investment, which provided the initial impetus for the turnaround last winter, may slow in the year ahead because of the recent rise in long-term interest rates. And the continued appreciation of the dollar in international exchange markets, related to the high budget deficit and high interest rates, gives credence to the view that the international sector is likely to remain a major drag on the economy; imported goods will continue to gain a competitive advantage in domestic markets while exports will be discouraged.

The strength and durability of the recovery will ultimately depend upon the behavior of inflation and real interest rates. Interest rates have not declined to the levels usually experienced during the early stage of a recovery. Although nominal short-term rates during the second quarter of 1983 were nearly five percentage points below their peak of a year earlier, real rates are still very high for this stage of the business cycle (see Figure 2). Longer-term rates have also remained high, perhaps reflecting expectations of increased inflation and fears that large federal deficits will persist in the later stages of the recovery because of failure to implement the budget resolution or to take further steps to curb deficits. Although their impact does not yet appear to have been very large, high real interest rates are likely to have substantial effects on longer-run growth.

THE CBO ECONOMIC FORECAST

The revised CBO forecast shows a more rapid recovery in 1983 than projected last February, although the projected rate of growth during the first year of recovery is still below the average postwar cyclical recovery rate of about 7 percent. The projection assumes that the policies embodied in the budget resolution are enacted and that nominal GNP growth will be in line with the Federal Reserve's monetary policy targets and the objectives set forth by the Administration.

The revised CBO forecast incorporates the following policy assumptions:

- The tax and spending policies of the First Budget Resolution for Fiscal Year 1984 are assumed to be carried out. On a unified budget basis these assumptions result in outlays of $807 billion in fiscal year 1983 and $860 to $868 billion in fiscal year 1984, depending upon the final disposition of the reserve fund included in the budget resolution. 2/

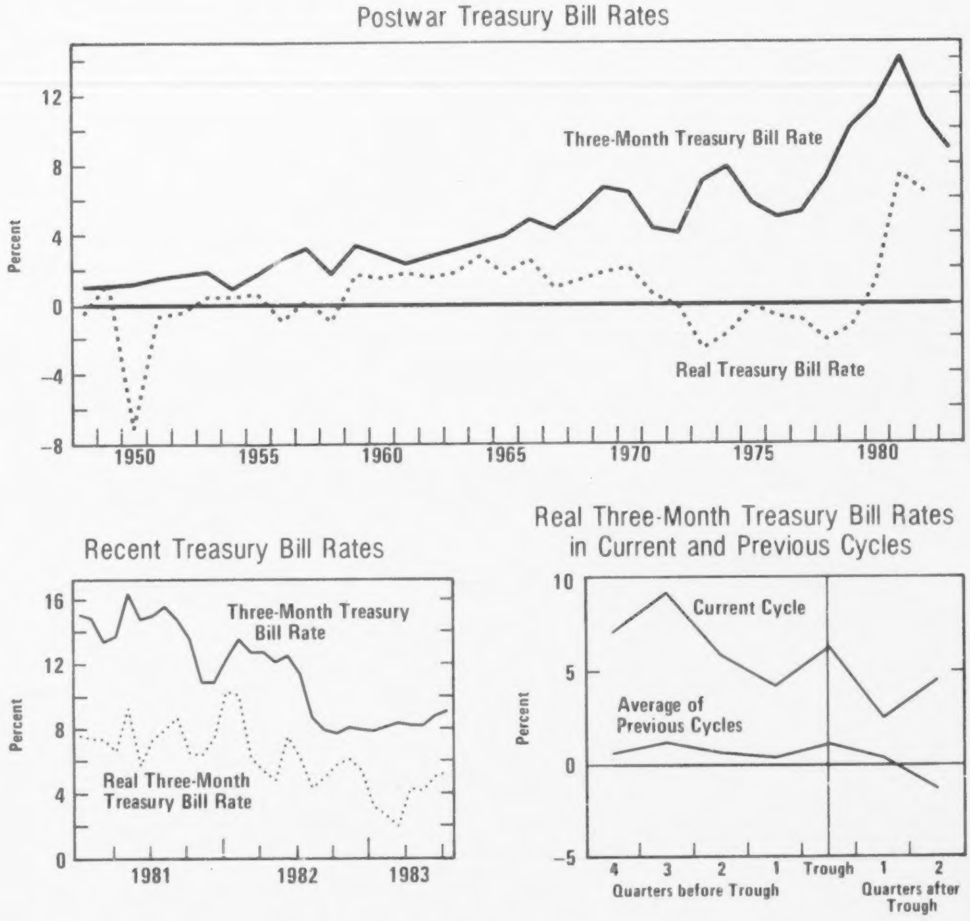
- Money aggregates are assumed to grow within the Federal Reserve target ranges.

The forecast also assumes no commodity price shocks. The refiners' acquisition cost of foreign oil is assumed to be flat in nominal terms through 1984, and food prices are assumed to rise less than the general price level.

2/ The First Budget Resolution for Fiscal Year 1984 included a "reserve fund" for antirecession assistance, which will be included in the spending ceiling if Congress authorizes the new programs.

Figure 2.

Short-Term Interest Rates



SOURCES: Federal Reserve Board; Congressional Budget Office.

NOTE: Real rates are nominal rates adjusted for inflation in the succeeding three months.

The forecast (Table 2) shows real GNP growing at 5.8 percent over the four quarters of 1983 and at 4.3 percent during 1984. The unemployment rate is projected to decline to 8.9 percent by the end of 1983 and to 8.2 percent by the end of 1984. Consumer spending is expected to grow rapidly in the second half of this year. Business investment is expected to make a major contribution to growth in 1984 in response to the cyclical increase in capacity utilization, and to business tax cuts. The rise in interest rates in recent months, in part reflecting the Federal Reserve's efforts to slow the rapid growth in money, is expected to have a moderating effect on residential construction and other interest-sensitive sectors later this year and in 1984.

Prices, as measured by the GNP deflator, are projected to rise by 4.6 percent this year (fourth quarter to fourth quarter) and by 5.0 percent in 1984. The projected increase in inflation in 1984 results from increases in Social Security taxes, an assumed decline in the value of the dollar in international exchange markets, tighter labor markets, and further restoration of profit margins as the recovery proceeds. The Consumer Price Index is also expected to show some acceleration in inflation in 1984. Short-term Treasury bill rates are projected to decline gradually from present levels of about 9.5 percent to 8.6 percent in calendar 1984. Long-term interest rates are projected to decline slightly in 1984.

TABLE 2. THE CBO SHORT-RUN FORECAST

	Actual	Projections	
	1982	1983	1984
Fourth Quarter to Fourth Quarter (percent change)			
Nominal GNP	2.6	10.6	9.5
Real GNP	-1.7	5.8	4.3
GNP Implicit Price Deflator	4.4	4.6	5.0
Calendar Year Average (percent)			
Unemployment Rate	9.7	9.7	8.4
Three-Month Treasury Bill Rate	10.6	8.8	8.6

Uncertainty in the Short-Run Economic Outlook

The most uncertain components of the economic projection are the future behavior of real interest rates and inflation. A resurgence of inflation or a substantial rise in interest rates could result in another period of cyclical decline. Fiscal and monetary policy appear to be the major source of uncertainty in the outlook for inflation and for credit conditions. Many observers fear that the budget issues will not be resolved quickly and that the absorption of savings by the federal sector, which has recently been at record rates (see Figure 3) will continue at a high rate during the year ahead. Given recent signs of strength in the economy, competition for funds between the federal government and others could emerge quickly, resulting in more stringent credit conditions than projected by CBO. This would have adverse effects on housing and other interest-sensitive sectors as well as on net exports. On the other hand, interest rates could turn out to be lower than forecast or their effects on demand less pronounced. Thus far, in the current recovery, forecasters have underestimated the strength of demand in the face of high interest rates.

In regard to monetary policy, it is not clear whether the Federal Reserve will attempt to rein in money growth, especially in view of the precarious foreign debt situation of developing countries and the opposition to higher interest rates expressed by some members of the Administration and the Congress. As a result of the recent decline in velocity—the ratio of GNP to the money stock—there is also an unusual degree of uncertainty concerning the economic effects of Federal Reserve money targets. 3/ The rapid growth in money during the past year could lead to a surge in economic growth, if there is a snapback in velocity. On the other hand,

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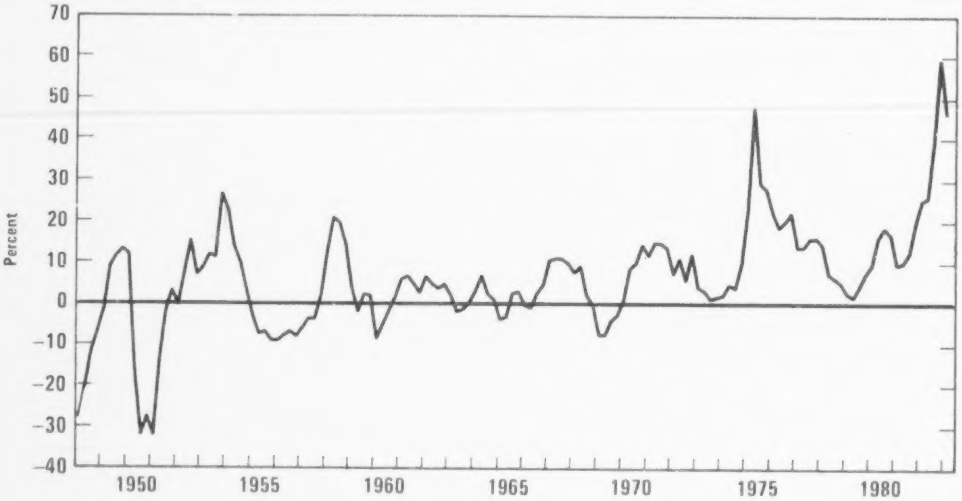
3/ From the end of 1981 through the first quarter of 1983, M1 velocity—the ratio of GNP to the narrowly defined money stock—declined by an unprecedented 6.9 percent, and in the second quarter it remained about 7 percent below the trend established in the 1960-1980 period. Although past experience indicates that a cyclical rebound in M1 velocity is likely, velocity may not return to the earlier trend path if the fall in velocity resulted from declining inflation expecations or from changes in regulations pertaining to bank deposits. The average increase in M1 velocity is about 5½ percent during the first four quarters of a cyclical recovery. However, velocity declined sharply in the first quarter of this year and increased only slightly in the second, suggesting that a normal cyclical rebound may not occur. Thus, it now appears that a wide range of nominal GNP growth could be implied by a given M1 growth target.

Figure 3.

Federal Deficit as a Percent of Gross Saving



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Federal Reserve policies to limit money growth may turn out to be more restrictive than intended.

Economic Projections for 1985 and 1986

Table 3 compares the CBO economic projections through 1986 with the Administration's projections and the economic assumptions of the recently enacted budget resolution for fiscal year 1984. These projections do not differ greatly, although the CBO projections incorporate more recent information on unemployment rates.

The CBO projections for the 1985-1986 period are not forecasts; rather they are noncyclical projections that assume that the economy moves gradually toward higher employment levels. Nominal GNP growth is assumed to decline in line with reduced money growth. In real terms, GNP growth is assumed to be 4.0 percent in calendar 1985 and 3.5 percent in calendar 1986. It is further assumed that no price shocks occur and that productivity grows at a trend rate of 1½ percent per year. This projection

TABLE 3. SUMMARY COMPARISON OF ECONOMIC ASSUMPTIONS (By calendar year)

	Actual	Estimated	Projections		
	1982	1983	1984	1985	1986
Real GNP (percent change, year over year)					
First budget resolution	-1.9	2.8	5.1	4.1	3.7
Revised CBO	-1.9	3.1	5.0	4.0	3.5
Administration	-1.9	3.1	5.2	4.2	4.0
GNP Deflator (percent change, year over year)					
First budget resolution	6.0	4.7	4.6	4.7	4.3
Revised CBO	6.0	4.5	4.8	4.8	4.8
Administration	6.0	4.6	4.8	4.9	4.6
Unemployment Rate (percent, annual average)					
First budget resolution	9.7	10.1	9.3	8.5	7.9
Revised CBO	9.7	9.7	8.4	7.9	7.5
Administration a/	9.7	10.1	9.1	8.4	7.5
3-Month Treasury Bills (percent, annual average)					
First budget resolution	10.6 b/	7.8	7.4	7.2	6.6
Revised CBO	10.6 b/	8.8	8.6	7.7	7.4
Administration	10.7 c/	8.6	8.5	7.8	7.2

a/ Administration's total resident unemployment rate plus 0.2 to approximate the civilian rate.

b/ Current market yield.

c/ Average rate on new issues, bank discount basis.

implicitly requires that the recovery last longer than most other recoveries since the war, despite considerable uncertainty over monetary and fiscal policy.

THE CBO BUDGET PROJECTIONS

Last February CBO's baseline budget projections showed federal budget deficits rising indefinitely from current record levels with the deficit to GNP ratio holding to about 5.6 percent during the 1984-1986 period. But the budget resolution adopted in June will turn this around if it is implemented. Under the policies of the resolution, and given the improved economic outlook, CBO estimates that the budget deficit will decline from about $207 billion in the current fiscal year to about $146 billion in fiscal year 1986 even if the reserve fund is spent. As a percent of GNP, the deficit will decline from its current level of about 6 percent to about 3 percent in 1986 (see Table 4).

The federal deficit for the current fiscal year is now estimated to be about $13 billion higher than anticipated last February, reflecting both higher outlays and lower revenue collections. Despite the higher 1983 deficit, CBO's revised budget projections show a $5 to $14 billion lower deficit in fiscal year 1984 and an $85 to $88 billion lower deficit in fiscal year 1986 depending on the outcome of the reserve fund. Most of the near term reduction is accounted for by recently enacted budget measures (including the Social Security amendments of 1983) and stronger economic growth. The major impact of policy changes called for in the budget

TABLE 4. CBO UNIFIED BUDGET PROJECTIONS GIVEN POLICIES OF BUDGET RESOLUTION FOR 1984 (By fiscal year)

	Actual	Estimate	CBO Projections		
	1982	1983	1984	1985	1986
			In Billions of Dollars		
Revenues	618	600	677	748	842
Outlays	728	807	860 to 868	924 to 929	986 to 989
Deficits	111	207	183 to 192	176 to 180	143 to 146
			As a Percent of GNP		
Revenues	20	19	19	19	20
Outlays	24	25	24	24	23
Deficit	4	6	5	5	3

resolution does not occur until after 1984. By 1986, they account for about 75 percent of the reduction in the projected deficit.

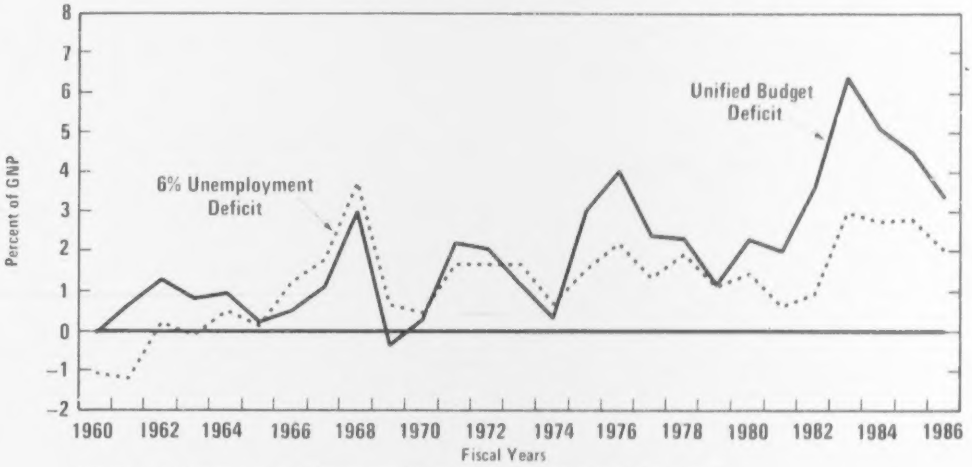
Both the budget resolution and the Administration's budget proposals would have a similar effect on the overall deficit in the next several years, but they differ sharply in their policies. The composition of spending is the major issue: the Administration seeks significantly higher levels of defense spending and much lower levels of nondefense spending. The Administration has proposed somewhat greater overall spending reductions, and tax increases that are smaller until 1986. Because of these differences in the policies of the Congress and the Administration, there is a strong possibility that the deficit reduction measures will not be realized.

Structural Deficits

Much of the current deficit is the result of recession, but even after recovery the federal budget will show large deficits (see Figure 4). These "structural" deficits will be over $100 billion in fiscal year 1985, even

Figure 4.

Federal Deficits as a Percent of Gross National Product



SOURCES: Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

if the policies of the resolution are enacted. The structural deficit will not decline until 1986. However, by then it will be substantially below CBO's estimate made last February before enactment of the resolution (see Table 5). (Estimates of the structural deficit for fiscal years 1983-1984 have been increased since February because of policy changes enacted since that time, a variety of technical reestimates, and higher interest costs). Even though the structural deficit will be substantially reduced in 1986 under the policies of the resolution, it will be very high in absolute terms, suggesting the possibility of high interest rates and crowding out of productive investment during the recovery. Without the resolution policies, or similar deficit-reducing measures, the deficit will rise relative to GNP, causing an even greater strain in financial markets.

TABLE 5. THE STANDARDIZED EMPLOYMENT DEFICIT a/

	Actual	Estimate	Projection		
	1982	1983	1984	1985	1986
		In Billions of Dollars			
February 1983 estimate b/	29	69	91	128	159
August 1983 estimate c/	29	97	99	110	87
		As a Percent of Standardized GNP			
February 1983 estimate b/	0.9	2.0	2.5	3.1	3.6
August 1983 estimate c/	0.9	2.8	2.6	2.7	2.0

a/ Unified budget estimate standardized at 6 percent unemployment.

b/ Congressional Budget Office, The Outlook for Economic Recovery (February 1983). The 1982 levels have been revised to reflect the revisions in economic data for that year.

c/ These estimates exclude expenditures from the "reserve fund". If enacted, the programs included in the reserve fund would cost $9 billion in fiscal year 1984, $5 billion in 1985, and $4 billion in 1986, given CBO's economic projections. The cost would be less at full employment because spending for these programs is likely to be sensitive to the level of unemployment.

CONCLUSION

Economic growth has been stronger and inflation lower in the first half of 1983 than anticipated by CBO last winter. But the recovery still appears to be precarious because of high interest rates and uncertainty concerning the future course of both monetary and fiscal policy. While the more rapid recovery tends to reduce federal budget deficits, it also brings closer the time when competition for credit between the public and private sectors will intensify. High deficits raise the risk (1) that tight credit conditions will choke off the recovery in interest-sensitive sectors of the economy; or (2) that the Federal Reserve will monetize large portions of the deficit, thereby ensuring the resurgence of inflation. Thus, enactment of suitable policies that substantially reduce future deficits could make a major contribution to sustained noninflationary growth.

Even if the economic recovery is stronger than projected, the budget deficits will remain very large without further deficit-reducing measures. The budget resolution enacted in June begins the process of reducing the deficits. But the resolution was merely the first step. Decisive action by the Congress and the Administration is necessary to ensure that these or other deficit-reducing measures are actually put into effect.

CHAPTER II. THE BEGINNING OF ECONOMIC RECOVERY

The recovery from recession is well under way. Although economic activity was below standard in the first quarter of the recovery, it picked up sharply in the spring and appears to be gaining momentum. [1] Preliminary figures show real GNP increasing at an 8.7 percent annual rate in the second quarter of 1983, considerably faster than had earlier been thought. Industrial production and employment are growing rapidly, and the civilian unemployment rate fell from 10.8 percent in December to 9.5 percent in July.

The growth of output in the second quarter was mainly the result of a surge in consumer spending, which was weak in the early months of recovery but picked up sharply in April and May. Car purchases accelerated in response to lower market interest rates and interest subsidies, and purchases of household furniture and appliances rose as consumers began to equip newly built houses. The growth of consumer purchases greatly exceeded the reported growth in disposable incomes, with the result that the saving rate fell to 3.9 percent in the second quarter, a very low level.

While areas of weakness remain, notably in net exports, the economic recovery is now quite strong. In addition, inflation has fallen dramatically. Particularly important are the decline in oil prices, the strength of the dollar, and the deceleration of wage growth.

What has triggered the recovery?

- Monetary policy and credit conditions eased about a year ago. Interest rates remain high, but have fallen from the high levels of last summer.
- The federal deficit has increased sharply, even after allowing for the effects of the recession, implying a very large fiscal stimulus to the economy this year.

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[1] Real GNP increased at an annual rate of 5.6 percent in the first two quarters compared to an average of 8.0 percent in the first two quarters of postwar recoveries. The National Bureau of Economic Research has dated the trough of the recession at November 1982. Thus the first quarter of recovery was the first quarter of 1983.

- The episode of inventory reduction, the largest in the postwar era, which has dominated the recent recession appears to be near its end, setting the stage for increased production to meet consumer demand. Inventories fell only slightly in the second quarter.

These developments have created the potential for a rapid increase in economic activity in coming months. As a result of the surge in consumer spending, business inventories declined sharply relative to sales in the second quarter, pointing to continued rapid growth in employment and output in the current quarter. The resulting growth in income, together with the July personal tax cuts, will permit still further growth of consumption. Consumers' confidence, too, has been rising strongly, suggesting further growth in purchases of durable goods and of housing.

Questions remain. The recovery has been strongest in housing, autos, and other consumer durables, all of which are sensitive to interest rate movements. But interest rates are high, and have recently been rising. Continued increases could hold back the recovery in these sectors. High interest rates could also keep the exchange value of the dollar high and worsen the U.S. trade deficit even more, and they could limit the recovery of inventories and slow the growth of housing investment. Thus confidence in the strength of the recovery must be tempered with concern over the impact of high real interest rates.

This chapter examines the current state of the economy, with particular emphasis on:

- The recent upturn in production, employment, and inventories;
- Prices, interest rates, and exchange rates; and
- The sources of prospective growth that must support a continued recovery.

Table 6, Table 7, and the box summarize recent economic developments.

THE UPTURN IN PRODUCTION

After a year and a half of recession, the U.S. economy is now growing rapidly. The recession led to a substantial reduction in inflation, particularly in commodity prices but also in wages, and it is unlikely that high rates of inflation will return soon. Although the cost of the improvement in

TABLE 6. QUARTERLY INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rates, unless otherwise noted)

	1981:4	1982:1	1982:2	1982:3	1982:4	1983:1	1983:2
Real GNP	-4.9	-5.5	1.0	-1.0	-1.3	2.6	8.7
Final sales	-2.3	-1.3	-0.8	-1.5	4.5	0.6	5.5
Personal consumption expenditures	-3.0	2.4	3.1	0.9	3.6	2.9	10.0
Durable goods	-22.9	11.3	3.0	-3.7	15.2	7.6	32.4
New autos	-55.6	61.6	4.7	-7.7	73.7	-10.8	79.5
Nondurable goods	0.3	-1.4	1.1	1.3	1.5	3.2	5.9
Services	1.4	2.9	4.7	2.1	1.9	1.4	6.8
Fixed investment	-7.8	-10.4	-9.3	-9.6	2.7	8.8	15.6
Nonresidential	-1.6	-5.9	-14.3	-8.8	-6.6	-1.5	4.6
Structures	7.8	-1.7	-2.6	-7.2	-5.5	-13.9	-14.0
Producers' durable equipment	-5.5	-7.8	-19.3	-9.6	-7.1	5.0	14.2
Residential	-30.2	-28.5	17.9	-13.0	53.2	57.3	61.1
Government purchases	3.9	-0.2	-5.0	9.4	10.6	-8.8	-0.9
Federal	10.0	0.2	-14.0	26.3	28.3	-18.0	-0.6
Defense	7.5	-1.3	13.0	14.0	5.1	6.5	14.1
Nondefense	15.0	3.3	-52.2	59.8	92.5	-52.6	-29.4
State and local	0.2	-0.5	1.3	-0.4	-0.1	-1.8	-1.0
Net exports (billions of 1972 dollars)	39.9	35.2	33.4	24.0	23.0	20.5	10.2
Change in business inventories (billions of 1972 dollars)	6.0	-10.2	-3.4	-1.3	-22.7	-15.4	-4.5
Real disposable personal income	-1.4	-3.4	1.9	-0.3	2.6	2.9	3.0
Saving rate (percent)	7.5	6.1	5.9	5.6	5.4	5.4	3.9
Industrial Production	-16.4	-12.0	-6.3	-3.4	-8.1	9.8	17.8
Unemployment Rate (percent, including resident armed forces)	8.2	8.7	9.3	9.8	10.5	10.2	9.9

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; and U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 7. STAGES OF RECESSION AND RECOVERY: CHANGES IN THE COMPONENTS OF REAL GROSS NATIONAL PRODUCT
(In billions of 1972 dollars, at annual rates)

	Full Recession (1981:3 to 1982:4)	First Stage (1981:3 to 1982:1)	Second Stage (1982:1 to 1982:3)	Last Stage (1982:4)	Early Recovery (1982:4 to 1983:2)
Gross National Product	-45.1	-40.0	-0.1	-5.0	40.7
Inventory change	-38.8	-26.3	8.9	-21.4	18.2
Final sales	-6.3	-13.8	-8.9	16.4	22.5
Consumption	16.6	-1.5	9.6	8.5	30.9
Business equipment	-15.2	-4.2	-9.0	-2.0	5.0
Business structures	-1.3	0.8	-1.3	-0.7	-3.8
Residential	-2.5	-6.8	0.2	4.1	10.6
Defense	7.0	1.1	4.9	1.0	4.1
Federal nondefense	5.6	1.7	-2.6	6.5	-10.3
Excluding CCC	-1.3	-1.1	-1.1	1.0	0.6
State and local	0.2	-0.1	0.4	-0.1	-1.2
Net exports	-16.8	-4.6	-11.2	-1.0	-12.8
Exports	-22.5	-7.2	-5.4	-9.9	-2.3
Imports	-5.6	-2.5	5.8	-8.9	10.5
MEMO:					
Inventory Change Plus CCC Purchases a/	-31.9	-23.5	7.5	-15.9	7.3
Final Sales Excluding CCC Purchases	-13.2	-16.6	-7.5	10.9	33.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Commodity Credit Corporation (CCC) purchases of stocks of farm products are treated conventionally in the National Income and Product Accounts as a component of federal nondefense purchases and of final sales, although they are in many ways similar to inventory-building by farmers.

THE ECONOMY AT MID-1983

Recovery started in December 1982 from the deepest postwar recession, the second of two since 1980. Both recessions were brought on by monetary restriction aimed at bringing inflation under control. Lower interest rates after mid-1982 permitted the recovery to begin. Real GNP grew at a 2.6 percent annual rate in the first quarter and at an 8.7 percent annual rate in the second quarter of 1983.

Inflation has dropped dramatically in the last three years. The CPI grew only at a 2.9 percent annual rate in the first half of 1983.

Real consumption led the way out of the recession, increasing at a 7 percent annual rate in the first six months of 1983. Durable goods purchases, particularly for autos, furniture, and appliances, were responsible for much of the growth in consumption. Unseasonable weather caused an acceleration in energy purchases.

Personal savings dropped precipitously in the second quarter, according to preliminary reports. Interest income fell because of lower interest rates. Government transfers to persons increased less than usual in the first two quarters after the recession trough. Slowing of these income components and strong consumption cut the saving rate.

Inventories continued to decline in the first half of 1983, making the total inventory adjustment since the end of 1981 easily the largest in the postwar period. But the decline in the second quarter was small.

Net exports are still falling precipitously. Weak exports reflect the 50 percent appreciation of the dollar since mid-1980, as well as recession overseas. For the second time in two years, oil inventory reductions held imports down in the first half of 1983, but it seems likely that the deterioration in net exports will continue.

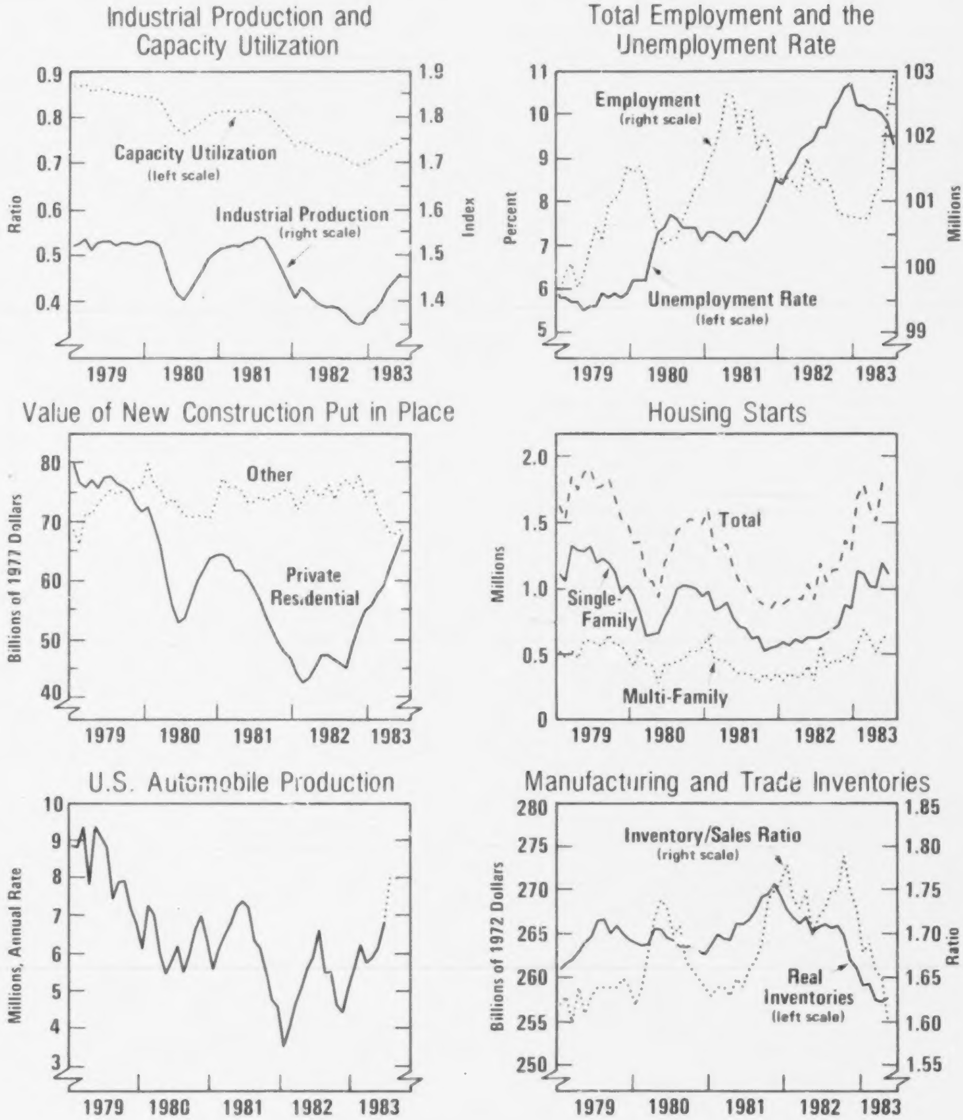
Crude oil prices fell sharply in early 1983, in response to reductions in refiners' inventories of petroleum products. The official OPEC marker price fell from $34 to $29. But product prices did not fall by the same amount, and as a result of the 5¢-per-gallon gasoline tax prices at the pump are now similar to what they were in mid-1982.

Unemployment dropped from 10.8 percent of the civilian labor force in December to 9.5 percent in July.

Housing starts began to rise in mid-1982 in response to lower interest rates, and are now 80 percent above year-earlier levels.

Figure 5.

Indicators of Economic Activity (Monthly)



SOURCES: Federal Reserve Board; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureaus of Economic Analysis and of the Census; *Ward's Automotive Reports.*

inflation was large in terms of lost output and unemployment, both output and employment have risen sharply in the first six months of 1983.

The recent improvement in output is evident from Figure 5. Industrial production has increased 8.2 percent since November, and total private manhours worked have increased 3.7 percent. Housing starts are 80 percent higher than last year.

Employment

From a high of 10.8 percent, the civilian unemployment rate has dropped to 9.5 percent. 2/ This is still above the previous postwar high of 8.8 percent reached in the 1975 recession. However, employment has increased rapidly since the recession trough, especially in July.

Increases in employment have been broadly spread across industries. In manufacturing, the index of hours worked rose about 8.5 percent in the eight months through July; durable goods manhours by 10.8 percent. In the transportation equipment (auto) industry, callbacks and overtime increases raised the hours index by 17 percent during the eight months. Altogether, 76 percent of industries showed increased employment in the first half of 1983.

Industrial Production

Output in manufacturing utilities and mining increased 8.2 percent from its cyclical trough in November through the end of June. Production in the auto industry has grown particularly fast, but almost all industries have shown some increase. The Federal Reserve Board's measure of capacity utilization in all industries rose from its cyclical low of 69.6 percent to 74.5 percent in June. This still leaves capacity utilization below normal at this stage of a recovery.

Since 1978 the auto industry, like housing, has suffered from rising prices and high interest rates that pushed the cost of financing new purchases out of the reach of many consumers. Through a series of rebates and below-market financing plans, combined with drastic production cuts in the fourth quarter of 1982, the industry was able to cut auto inventories and

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2/ Counting resident military personnel as part of the labor force, the unemployment rate fell from 10.7 percent to 9.3 percent.

return to more normal output levels in 1983. As a result unit auto production has increased 52 percent since the low in November, and current production schedules call for a further increase in the second half of 1983. The projected increase in auto production alone could add about 2½ percentage points (at an annual rate) to the growth of GNP in the third quarter.

Output has also grown rapidly over the past six months in the furniture and appliance industries, and in the primary metals industries whose output goes into durable goods. Much of the increase in industrial production has therefore depended directly or indirectly on the growth of demand in interest-sensitive sectors of the economy.

Construction Activity

Residential construction has been the star performer of the economy in recent months. Housing starts, which fell to less than 900,000 units at the end of 1981, began to rise in the middle of 1982, and in the second quarter of this year reached 1.7 million units at an annual rate. Housing permits, too, have continued to rise and in June were almost twice the level of a year earlier.

The impact of this increase in residential construction activity on the economy has not yet been fully felt.

- The construction time for a new home is 3 to 6 months, with construction activity spread over this whole period. The value of new housing units put in place (in constant prices) has risen 66 percent since its low in May 1982, while housing starts are up 80 percent: thus, it is likely that a further increase in construction activity is still to come, based on the housing starts that have already occurred.
- When houses are completed, they must be equipped with furniture and appliances. This shows up as personal consumption expenditures on durable goods: these categories have recently begun to increase rapidly.

The strength of residential construction has not extended to the nonresidential sector. Private nonresidential building was down 10 percent between May 1982 and May 1983: but for the tail end of a boom in office construction, the decline would have been larger. Even office construction has been trending down over the past six months, in response to an increase in office vacancy rates.

Private nonresidential construction normally lags behind other categories of investment at cyclical upturns, partly because businesses do not wish to commit themselves to long-term investment while still earning recession profits. But there are signs of recovery in nonresidential building. The value of construction contracts for future starts of nonresidential buildings is up about 40 percent since the recession low. Nonresidential building activity rose slightly in June, the first increase in seven months, and the increase was spread over most of the components.

Inventories

The recession ended in the last quarter of 1982 with a rapid runoff of inventories, particularly of automobiles. The change from inventory accumulation to inventory reduction accounted for about 86 percent of the decline in production over the full recession from 1981:3 to 1982:4. Overall, the inventory decline has been the largest in the postwar period (Figure 6).

Inventories continued to decline in the first half of 1983, though at a much reduced rate in the second quarter. Unsold auto stocks remained approximately level. Because auto sales have increased substantially over this period, auto inventories are now low relative to sales (about 47 days' supply instead of the 60 often regarded as normal). Stocks of crude oil and petroleum products, which fell from November to March (contributing to this spring's reduction in world oil prices) rose sharply in July. 3/

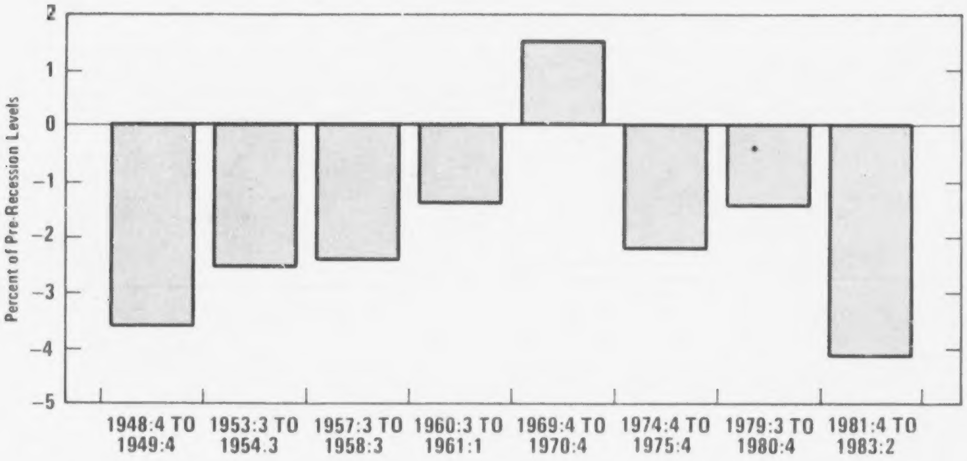
High real interest rates, and uncertainty over the outlook for the economy, may still be influencing inventory stocking decisions. But it is likely that the reason for inventory declines in the second quarter was instead the rapid growth in final sales, which rose at a 6.3 percent annual rate. 4/ As a result, the ratio of inventory to shipments in manufacturing dropped from 1.71 in December to 1.59 in March and again to 1.49 in June. Further growth in demand will require increased production (and employment) to replenish depleted inventory stocks.

3/ Part of this increase is a normal seasonal increase in heating oil stocks. But gasoline stocks also rose, contrary to the normal seasonal pattern.

4/ After adjustment for Commodity Credit Corporation inventory change, which is treated as final sales in the National Income and Product Accounts.

Figure 6.

Changes in Real Inventories in Postwar Recessions



NOTE: There was no inventory reduction in the 1970 recession, and change shown is between peak and trough dates. For other recessions, changes are over the inventory cycle.

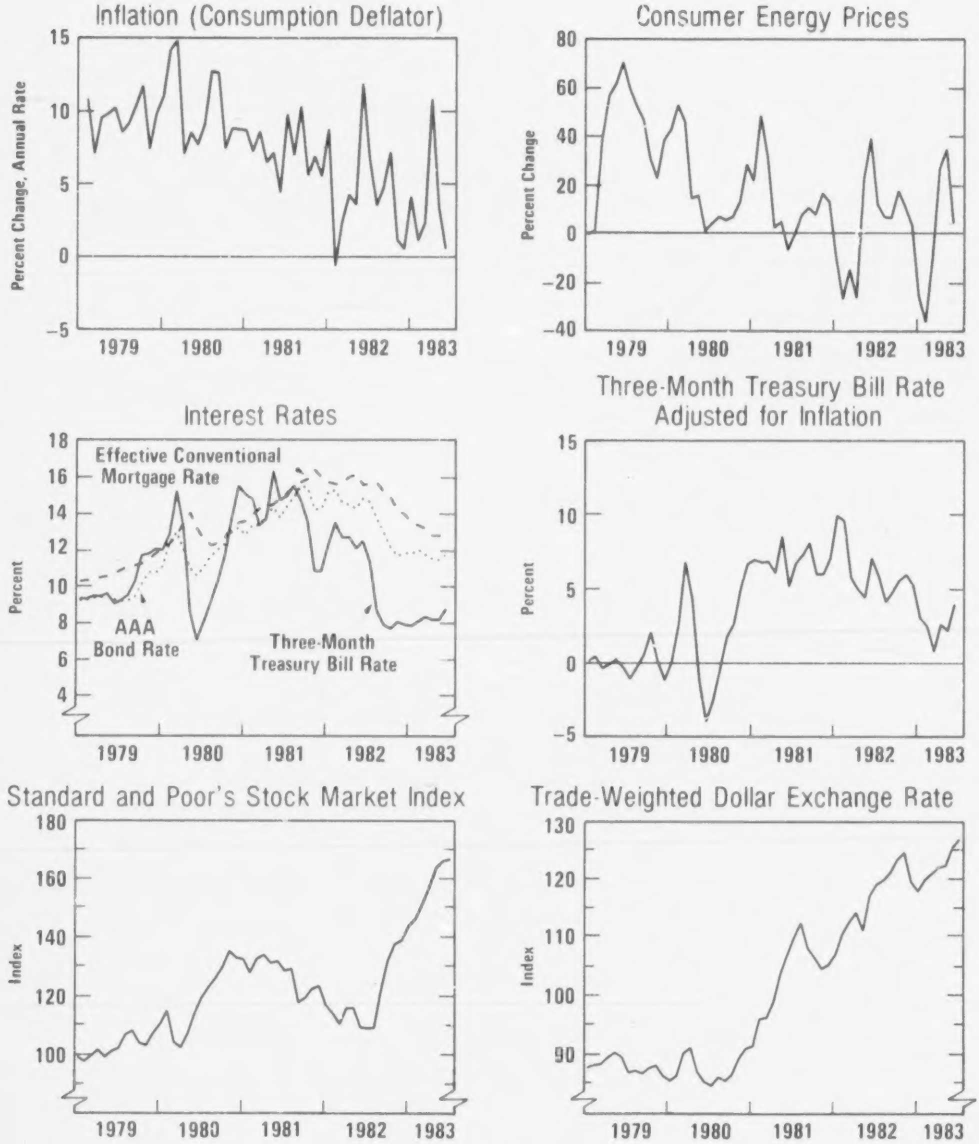
PRICES, INTEREST RATES, AND EXCHANGE RATES

A dramatic decline in inflation, a fall in interest rates from levels that were extraordinarily high to levels that are merely high, and the stock market boom have contributed to the improvement in economic conditions. Lower oil prices and a strong dollar have permitted rising real wages and helped to support consumption through the recession. But nominal wage growth itself has decelerated dramatically, both in the nonunion sector and in the major collective bargaining sector, which has often been more resistant to wage reductions in the face of recessions. Most analysts believe that the underlying rate of inflation has been sharply reduced over the past three years. But lower inflation so far has not been fully reflected in lower interest rates (Figure 7).

High interest rates continue to depress some sectors of the economy. They have kept the dollar exchange rate very high (some would argue, overvalued by about 20 percent relative to what it would be at more normal interest rates). The dollar's 50 percent appreciation since July 1980 has undoubtedly contributed to the fall in U.S. net exports. And high interest rates may also dampen the growth of residential construction and domestic investment, and restrict inventory rebuilding.

Figure 7.

Prices and Interest Rates



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Standard and Poor's; Federal Home Loan Bank Board.

This section examines the magnitude and durability of the decline in inflation, and looks at the effects of high interest rates and the strong dollar on the economy.

Reduction in Inflation

The impressive reduction in inflation in the past two years has continued in the first half of 1983. Consumer prices (measured by the CPI-U—the CPI for all urban consumers) fell in December and February, and rose at less than a 3 percent annual rate in the first half of 1983. Other inflation measures, too, have shown improvement recently: the Producer Price Index for finished goods actually fell from December to June and the fixed-weight GNP deflator, a broad measure of all prices in the economy, rose only 4.3 percent at an annual rate in the first half of the year. As recently as 1980, by contrast, the fixed-weight GNP deflator rose 9.6 percent and the PPI for finished goods rose 13.5 percent.

The reduction in inflation has reflected three factors:

- Much slower wage growth;
- Lower commodity prices, in particular lower oil prices; and
- A strong dollar, which has cut the cost of imports and trimmed margins in U.S. industries that engage in foreign trade. Lower import prices account for slower growth in the CPI than in the GNP deflator, which excludes imports.

Both the reduction in wage growth and lower commodity prices are the result of recession here and overseas. Stubbornly high U.S. interest rates, as well as uncertainties related to the debt crisis in developing countries, are responsible for the high exchange value of the dollar. Some analysts fear that recovery from recession, and perhaps a weakening dollar, could cause inflation to accelerate again. The likelihood of a quick acceleration in inflation does not seem great, however. Productivity growth is expected to be strong, so wages could grow much faster than they have recently without much impact on inflation. Some commodity prices are already responding to the recovery in economic activity. The grain harvest is expected to be down about 40 percent in 1983: this may push up meat prices in the second half of 1984, but large grain stocks and a good harvest next year would prevent a serious acceleration in food prices. Excess capacity in the oil industry seems sufficient to hold oil prices at their current levels through the end of 1984. A serious possibility for a resurgence of inflation lies in a fall in the exchange rate. A 10 percent fall in the course of a year might temporarily add about one percentage point to inflation—pushing the current underlying rate of inflation from the neighborhood of 5 percent to that of 6 percent. (At the same time, a decline in the dollar would stimulate U.S. output and employment). In addition, if the recent rapid growth in the money supply raises expected inflation, it may lead to higher wage claims and higher prices.

Oil Prices. World oil prices, which have been weak since 1980, dropped sharply early in 1983. World demand for oil products dipped in the recession, leaving refiners, distributors, and end users with excessive inventories of refined petroleum products that pushed down product prices in the second half of 1982. The OPEC oil producers had faced a similar situation earlier in 1982, but managed to avoid crude oil price cuts by an informal (and leaky) system of production rationing. OPEC was not so successful against the inventory drawdown at the beginning of 1983, which forced drastic cuts in crude oil prices and a more formal system of allocation of production. The final agreements, reached in March, called for a cut in the price of the Saudi marker crude from $34 to $29 per barrel.

Since April, it appears that market crude oil prices (though not official prices) have risen by about $1 per barrel. A new five-cents-per-gallon federal gasoline tax was introduced in April. Product prices have apparently risen by even more than this, and in July gasoline prices were only 3½ percent lower than their levels in mid-1982. Thus as far as the U.S. consumer is concerned, the oil price changes of early 1983 have been largely reversed.

Slowing of Wage Growth. A dramatic slowing of wage growth underlies the reduction in inflation (Table 8). This has been most visible in major national wage bargains struck over the past two years, which have frequently included one or more unusual features:

- Freezes or rollbacks of general wage increases, which in the past have included catch-up adjustments for previous inflation as well as increases in real wages (often at a rate averaging 3 percent per year);
- Delayed cost-of-living adjustments; and
- Shortened contract periods.

Contracts settled in the first half of 1983 included the smallest wage increases on record for major collective bargains. The average wage

TABLE 8. MEASURES OF WAGE AND COMPENSATION CHANGE FOR THE NONFARM BUSINESS SECTOR (In percent)

	Year Ending					
	Dec. 1978	Dec. 1979	Dec. 1980	Dec. 1981	Dec. 1982	June 1983
Compensation Change						
Compensation per Man-hour a/	8.9	9.6	10.8	9.0	7.2	6.1
Employment Cost Index b/	N/A	N/A	9.8	9.8	6.4	6.3
Union	N/A	N/A	N/A	10.7	7.2	7.0
Nonunion	N/A	N/A	N/A	9.4	6.0	5.9
Major Collective Bargaining Agreements c/						
First year	8.3	9.0	10.4	10.2	3.2	3.1
Average over life of contract	6.3	6.6	7.1	8.3	2.8	3.4
Wages and Salaries Change						
Average Hourly Earnings Index d/	8.5	8.3	9.2	8.2	6.0	4.6
Employment Cost Index b/	7.7	8.7	9.0	8.8	6.3	5.4
Union	8.0	9.0	10.9	9.6	6.5	5.6
Nonunion	7.6	8.5	8.0	8.5	6.1	5.4
Major Collective Bargaining Agreements e/						
First year	7.6	7.4	9.5	9.8	3.8	2.8
Average over life of contract	6.4	6.0	7.1	7.9	3.6	3.7

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Quarterly data, not adjusted for change in overtime or in industry or occupation mix.

b/ Adjusted for changes in overtime, and in industry and occupation mix.

c/ Settlements in the period covering 5,000 or more workers.

d/ Adjusted for overtime in manufacturing and for industry-mix changes.

e/ Settlements in period covering 1,000 or more workers. Excludes cost of living adjustments.

RECENT MAJOR COLLECTIVE BARGAINING AGREEMENTS

Major settlements in the past two years have often broken from the pattern of the last two decades by calling for no general wage increases or in some cases for actual givebacks. It is still too soon to know whether the pattern will be reestablished with economic recovery and more competitive exchange rates, or whether the changes will be permanent. Some major settlements:

Autos. No general wage increases, and reduced cost-of-living adjustments (COLAs). In exchange, job security improved. Chrysler workers got back some of their earlier wage cuts, but failed in 1983 to negotiate further catch-up with the rest of the industry.

Rubber. No general wage increases, but COLAs retained and pension and insurance benefits improved.

Trucking. No general wage increases, though economic provisions can be renegotiated early if financial conditions improve. Semiannual COLAs changed to annual, and part of the COLA can be diverted to maintaining current pension, welfare, and health benefits.

Meatpacking. A 3-year agreement gave back the wage increases in the old contract; COLA was suspended. In exchange, greater job security.

Electrical workers. This industry is in relatively good health: general wage increases continue, with improved COLAs and lay-off benefits.

Steel. A 41-month contract from March 1983 in effect before old contract expired. Base pay cut, to be restored in February 1986. COLAs suspended for five quarters, then reduced. Employee unemployment benefit contributions increased drastically, benefits for early retirement increased. Cost savings to be spent in the steel industry.

Aluminum. No general wage increase, COLA reduced slightly.

Farm Equipment. For most of the industry, there was no general wage increase but the COLA was maintained and a new profit sharing plan introduced. The settlement at International Harvester suspended the COLA for fifteen months.

adjustment in the first quarter was -1.4 percent for the first year of the contract, the first negative average in the 15 years the data have been collected. Wage adjustments were to be 2.7 percent over the lives of contracts settled in the first half of the year, compared with 6.7 percent the last time the same contracts were renegotiated (two or three years ago). These calculations do not reflect scheduled cost-of-living adjustments, but because of the reduction in inflation these too are likely to be smaller than in the past.

Major collective bargaining agreements cover less than 10 percent of all workers in the United States. But wage growth has slowed dramatically throughout the labor market. The employment cost index for compensation (including fringe benefits) of nonunion workers increased 6 percent from the first quarter of 1982 to the first quarter of 1983, down from 7 percent the previous year and 10 percent the year before that. The index for wages and salaries of nonunion workers slowed even more from 1982 to 1983, down from 7.5 percent to 5 percent. Average hourly earnings growth for all workers, including both union and nonunion workers, appears to have been running at about a 3 percent rate in the past six months, including the effect of some major wage cuts such as that in the steel industry.

Most analysts expect wage growth to accelerate, though not by very much. As production, employment, and corporate profits rise, there will be less pressure on wage bargainers to accept the freezes and givebacks that have dominated the recent picture. In addition, wages in some industries will accelerate as delayed cost-of-living adjustments come into effect—though their impact will be diminished by the very low recent increases in the CPI. Increases in employer contributions to Social Security will add about 0.3 percent to employee compensation in each of the next two years; wage growth may be held back a little by this, but by most estimates the effect should be very small.

Interest Rates

After declining sharply a year ago, short-term interest rates stayed close to 8 percent from September 1982 to May of this year, despite very low levels of economic activity and rapid growth in the money supply. By early August, however, the three-month Treasury bill rate had risen to about 9.5 percent. The long-term AAA corporate bond rate dropped from 15 percent in June 1982 to 12 percent in October, and remained within half a point of that level through May 1983, but has risen by about 1.4 percentage points since mid-May. The widely watched prime rate fell from 16.5 percent to 13.5 percent between June and September 1982, and then gradually eased down to 10½ percent, which it reached in March. It increased to 11 percent in early August. The effective interest rate on conventional mortgages dropped more slowly last fall than other rates, but continued to decline until recently and in early July was down to 12.6 percent (from 17 percent a year earlier). 5/ Secondary market rates for mortgages have since risen to about 13½ percent, and the FHA mortgage rate has also been raised from 12 percent to 13.5 percent.

While nominal rates have fallen from their early 1982 highs, reducing the costs of borrowing, real interest rates are still at almost unprecedented levels. It is difficult to measure the inflation premium that these rates embody, but if the CBO forecast of about 5 percent inflation is close to the expectations of market participants then the real rate on Treasury bills is about 4 percent and that on long-term bonds is 6 to 7 percent. Federal Reserve Chairman Volcker has estimated that many people expect inflation to rise to 7 percent in the long run. 6/ Even if this is correct, the implied real rate on long-term bonds is still about 4 to 5 percent. Real short-term rates are higher than at any time since the Depression.

The reduction in interest rates since last summer has also contributed to a large increase in household wealth. Lower interest rates increased bond prices directly, but also were a major factor in the rally in stock prices:

- The stock market probably anticipated improved sales of durable goods and other interest-sensitive items. In fact, as noted above, durable goods sales grew rapidly in the first half of 1983, producing a turnaround in corporate profits, especially of the auto companies.

- Lower real interest rates also raised the market's valuation of expected corporate earnings (because they would be discounted less).

- Lower nominal interest rates reduced the debt service of corporations, which have become increasingly leveraged in the postwar period and have recently financed much of their debt in the short end of the market. Thus, expected earnings and cash flow were improved.

5/ Rates reported by Federal Home Loan Bank Board.

6/ Before the Subcommittee on Economic Policy, Senate Banking Committee, July 28, 1983.

As a result, stock prices have risen 53 percent over the last twelve months. A later section will show that the increase in household wealth puts consumers in an excellent position to expand spending again, and may help explain the current low saving rate.

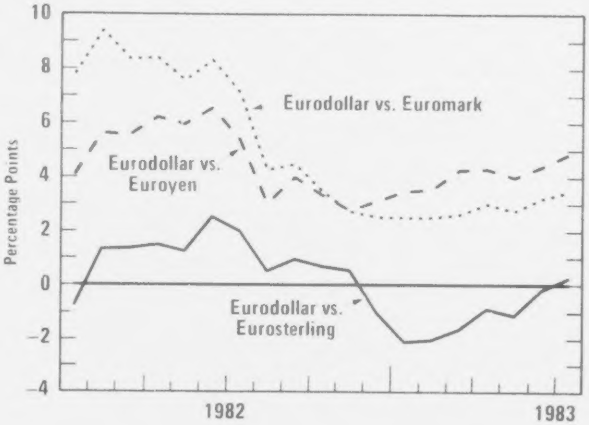
Dollar Exchange Rate

In the first half of 1983, the dollar climbed to record levels against the currencies of its major trading partners. By July, the trade-weighted value of the dollar stood nearly 50 percent above its July 1980 level. As a result the U.S. balance on current account dropped from a $4.5 billion surplus in 1981 to a $11.2 billion deficit in 1982, and in the first quarter of 1983 the deficit was $12.2 billion at an annual rate. The dollar maintained its strength in the face of these adverse trade flows because of a heavy influx of capital from abroad, drawn by high U.S. interest rates.

Nominal interest rates remained high in the United States even though inflation had slowed. Equally important, investors did not expect further reductions in U.S. interest rates. Given the desire of foreign central banks to lower their own interest rates, the interest rate differential did not seem likely to move against the United States in the foreseeable future. As shown in Figure 8, U.S. interest rates actually rose relative to foreign rates in the second quarter of 1983.

As the dollar continued to strengthen throughout July and into August, foreign governments and U.S. exporters renewed their calls for policies to stem the dollar's rise. These pressures, combined with a belief that foreign exchange markets were becoming disorderly, induced the U.S. government

Figure 8.
Eurodollar Interest Differentials



SOURCE: Reuters.

NOTE: Differentials are based on three-month Eurocurrency deposit rates.

to join its trading partners and intervene in currency markets in an attempt to moderate the dollar's rise.

The strong dollar has had mixed effects on the U.S. economy: it has severely damaged the competitiveness of U.S. industry in the world market, but has contributed to the slowing of inflation and wage growth in this country. In the rest of the world, the strength of the dollar has heightened the debt crisis in developing countries by increasing the cost of their debt repayments, and the price of oil, which is denominated in dollars, but it has also improved the competitiveness of their goods in the U.S. market.

The future course of the dollar will depend importantly on the monetary policies pursued by the Federal Reserve and other central banks. Central bank behavior must be gauged in the context of the current economic environment. It is now evident that economic recovery among U.S. trading partners will lag the U.S. recovery and may not be as strong. Unemployment rates have risen in these countries and inflation has fallen (Table 9). Thus foreign central banks are probably even more concerned than the Federal Reserve to lower their interest rates. If U.S. interest rates fall, the trading partners will seize the opportunity to push their own rates lower. If U.S. rates rise, it is unlikely that the trading partners will allow their interest rates to keep pace. Instead, foreign central banks may choose to accept the stimulative and inflationary effects of further depreciation rather than allowing significantly higher interest rates to undermine their economic recoveries. In the short term, therefore, it is unlikely that the interest rate differential will move against the United States, and the dollar is expected to remain strong.

Moreover, the United States remains a "safe haven" for investors in the general atmosphere of uncertainty created by the debt problems of developing nations--problems that have been exacerbated by the high interest rates.

Looking beyond 1983, the overvaluation of the dollar and the relatively rapid U.S. economic recovery point toward a continuing deterioration of the trade account and increasing downward pressure on the dollar. If U.S. interest rates decline sufficiently in 1984 to permit a narrowing of the interest differential, the trade sector will begin to assume its normal role in determining the value of the dollar.

SOURCES OF PROSPECTIVE GROWTH IN DEMAND

The recovery so far has been characterized by a sharp slowing in the rate of inventory reduction, strong growth in consumer spending, and a

TABLE 9. INFLATION AND UNEMPLOYMENT RATES IN THE UNITED STATES AND SEVEN OTHER MAJOR INDUSTRIAL COUNTRIES THROUGH THE FIRST QUARTER OF 1983

	United States		France		West Germany		Italy		Netherlands		United Kingdom		Japan		Canada	
	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U	$\dot{P}$	U
1978	7.7	6.1	9.0	5.3	2.8	4.3	12.1	3.7	4.1	4.1	8.3	5.5	3.8	2.2	8.9	8.4
1979	11.3	5.8	10.8	6.2	4.1	3.8	14.7	3.9	4.2	4.1	13.4	5.1	3.6	2.1	9.1	7.5
1980	13.5	7.1	13.5	6.7	5.5	3.8	21.2	3.9	6.5	4.8	18.0	6.4	8.0	2.0	10.2	7.5
1981	10.4	7.6	13.1	7.8	5.9	5.5	19.5	4.2	6.7	7.4	11.9	10.0	4.9	2.2	12.5	7.6
1982	6.1	9.7	11.9	8.4	5.3	7.5	16.3	4.8	5.9	10.1	8.6	11.7	2.7	2.4	10.8	11.0
1983:1	-0.27	10.3	11.1	8.8	2.0	8.9	14.7	5.2	.30	14.4	2.0	12.6	-1.3	2.7	2.4	12.5

$\dot{P}$ = Percentage change in consumer prices from preceding year (1983:1 calculated as percentage change from 1982:4, then annualized).

U = Rate of unemployment (as percent of civilian labor force).

SOURCE: U.S. Department of Commerce, International Economic Indicators (June 1983), pp. 43, 63.

recovery in housing. The equipment component of business fixed investment is also showing some early signs of improvement. But net exports are getting rapidly worse. With consumption growth running ahead of the growth in other demand categories, household income has lagged and the saving rate has fallen from over 5 percent in 1982 to 3.9 percent in the second quarter of 1983. This is the lowest saving rate in the past 30 years. Consumption growth clearly cannot be sustained at recent rates unless disposable personal income picks up.

In fact, near-term acceleration in disposable income seems very likely. The tax cut in the third quarter of 1983 will add about $30 billion to disposable income at an annual rate. There will be gains in spending throughout most of the economy, generating increases in personal income. The weakest outlook is in net exports, where the high exchange rate and poor growth among U.S. trading partners promise an even worse performance this year than last (see Figure 9).

This section examines recent developments in the major sectors of demand, pointing out their potential strengths and weaknesses in the months to come. A common thread in the analysis is the sensitivity of the recovery to interest rate changes: rising interest rates could choke off demand for housing and durable goods, increase even more the number of business failures, hold back investment growth, and worsen net exports.

The Consumer

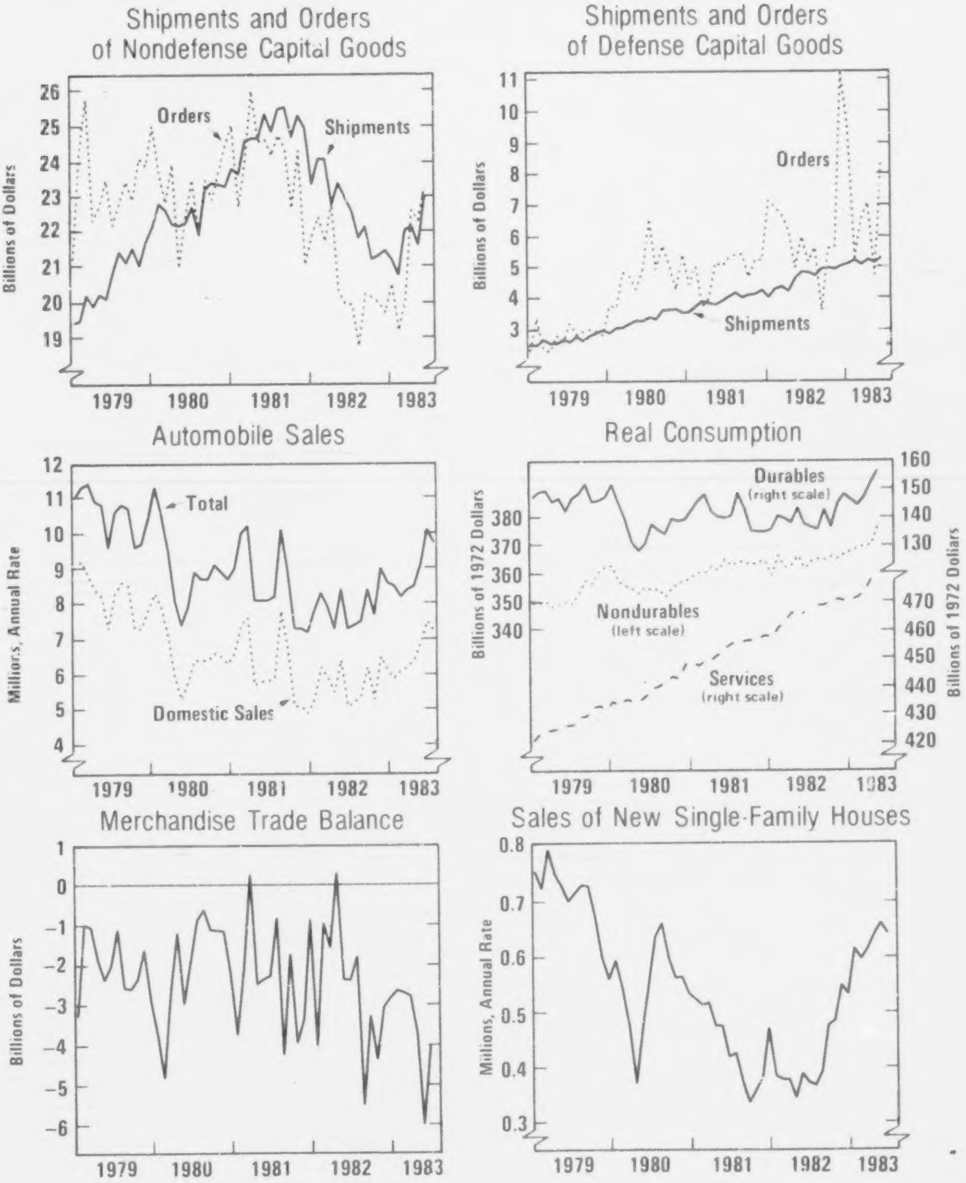
Consumption has grown rapidly in recent months, accounting for about three-quarters of real GNP growth in the first half of 1983. Most determinants of consumer spending point to further rapid increases:

- Tax cuts have given a substantial boost to disposable income in the last two years;
- Consumer confidence is high;
- Household wealth has increased substantially;
- Unemployment is falling and employment is growing; and
- The housing recovery has generated increased demand for durable appliances and furniture.

Consumption rose faster than income in the second quarter, pushing the reported saving rate down to 3.9 percent from 5.4 percent in the first

Figure 9.

Sources of Demand: Recent Movements (Monthly)



Shipments and Orders of Nondefense Capital Goods

Shipments and Orders of Defense Capital Goods

Automobile Sales

Real Consumption

Merchandise Trade Balance

Sales of New Single-Family Houses

SOURCE: U.S. Department of Commerce.

quarter. 7/ It seems unlikely that such low saving rates will be maintained, and further consumption growth will therefore require even more rapid growth in income.

Disposable Income. Real disposable income grew through the past recession, buoyed by tax reductions, low commodity prices, and high interest income. The growth occurred in spite of the sharp slowing of wage growth and rising unemployment, which tend to dampen income growth.

In the current recovery, however, disposable personal income has grown rather more slowly than in previous recoveries. Lower interest rates caused personal interest income to fall in the first two quarters of 1983. Government transfers to persons have also grown less than in typical recoveries, because of the rapid decline in unemployment and the increasing numbers of the unemployed who have exhausted their benefits. Other components of disposable income grew at about the same rate as in past cyclical upturns.

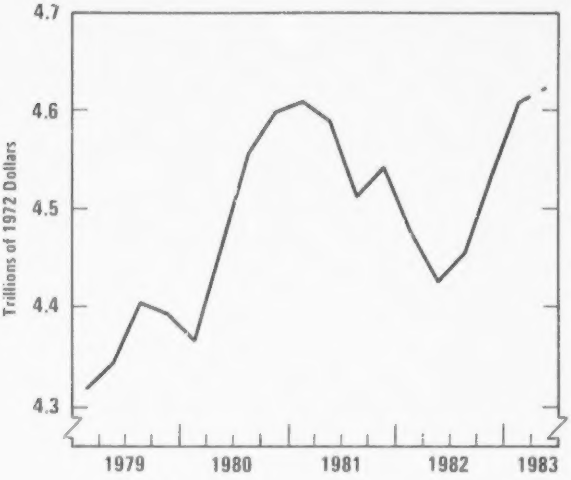
Tax changes point to a sharp increase in disposable income in the third quarter of 1983. The final installment of the 23 percent tax cut put in place by the Economic Recovery Tax Act of 1981 reduced tax withholding by about $30 billion in July, providing a temporary boost in the growth of consumption and saving in the third quarter. Looking further ahead, the Social Security tax increase at the beginning of 1984 will have no immediate effect on disposable personal income, since it is to be offset by a tax credit. (The employers' portion will not have a similar offset).

Household Wealth. Although consumer disposable income remained quite strong through the recession, household wealth deteriorated sharply until the middle of 1982. House prices ceased to grow as they had in the 1970s, and rising interest rates contributed to falling stock market values. Real household net worth fell by about 2.8 percent from 1979 through mid-1982.

Since the middle of last year, the financial situation of consumers has improved substantially:

7/ The swing in the saving rate was exaggerated by the weather. Warm winter weather reduced spending on heating in the first quarter, while the cool, wet spring meant more heating than usual in the second quarter. The heat wave in July and August seems likely to push up cooling demand in the third quarter.

Figure 10.
Household Net Worth



SOURCES:
Federal Reserve Board; Congressional Budget Office.

NOTE:
Projection for 83:2 based on increase in stock market prices.

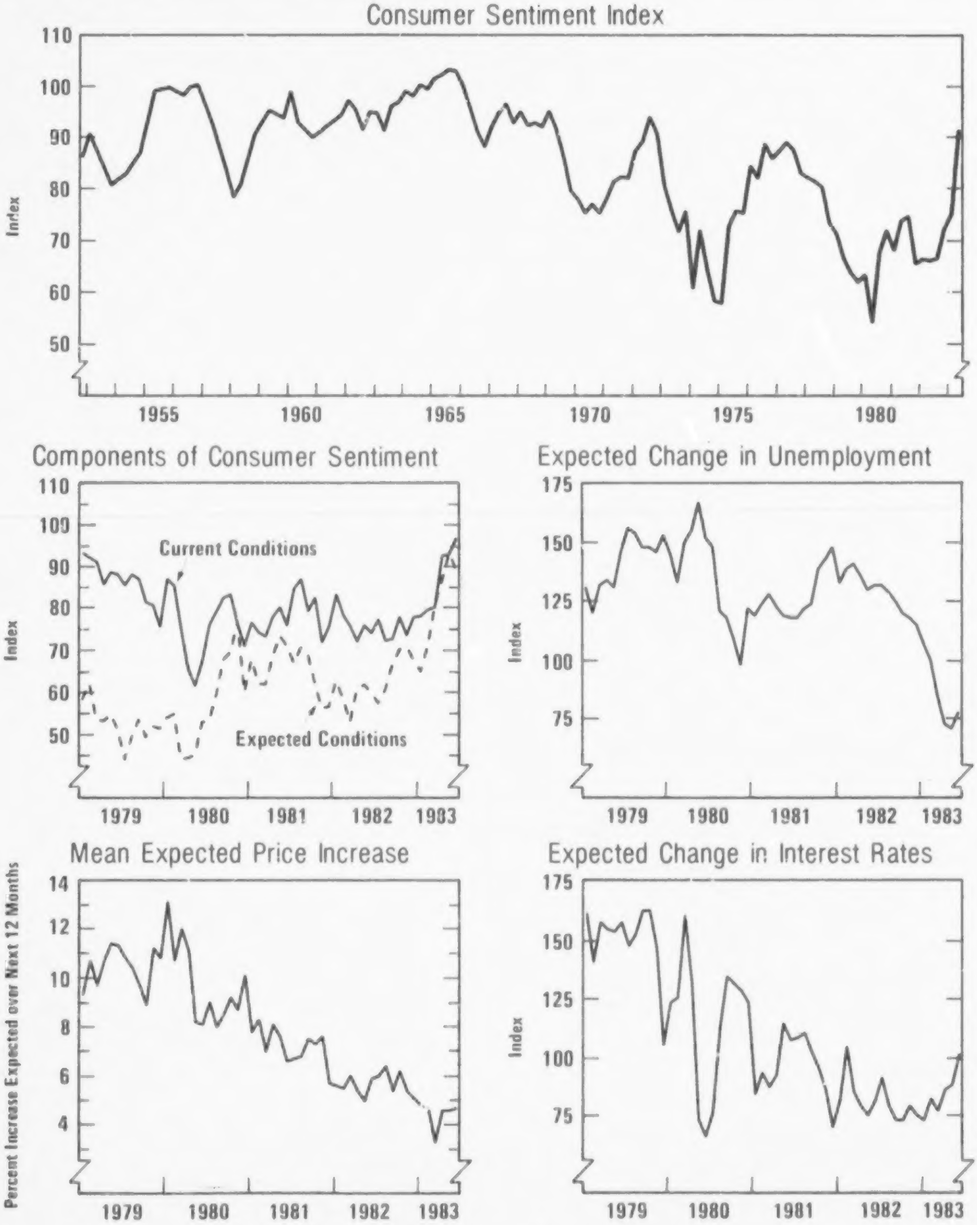
- The stock market boomed, in response to lower interest rates and the improved financial condition of corporations;
- Interest rates fell, raising bond prices and the value of the household holdings of bonds; and
- House prices began to rise again, as mortgage rates fell and the housing market improved.

As a result of these developments, household net worth increased by about 7.2 percent between the first quarters of 1982 and 1983, despite low personal savings (see Figure 10).

Consumer Confidence. Consumer confidence, too, sustained a remarkable rally in early 1983. The confidence measures of the Conference Board and the Michigan Survey Research Center are up by 67 percent and 52 percent from the levels of the third quarter of 1982 (Figure 11). The most rapid improvement has been since February. The rise in consumer confidence extends over almost all components of the Michigan index, suggesting fewer worries about unemployment and inflation, more awareness of lower interest rates, and the expectation of a resumption of economic growth. However, some analysts fear that the improvement in consumer confidence depends too much on the decline in interest rates from last year's levels, and that increases in interest rates, even modest ones, could quickly reduce

Figure 11.

Sources of Consumer Confidence



Consumer Sentiment Index

Components of Consumer Sentiment

Expected Change in Unemployment

Mean Expected Price Increase

Expected Change in Interest Rates

SOURCES: Survey Research Center, University of Michigan, Congressional Budget Office.

NOTE: Expected conditions are personal and business conditions one and five years ahead. Expected changes in unemployment, prices, and interest rates are for the next year.

confidence. Fewer consumers report that they expect further reductions in interest rates, so some of the recent strength in durables and housing could reflect advance purchases in anticipation of interest rate increases.

Saving

Why has consumption apparently run ahead of income, pushing the saving rate to unusually low levels?

- Preliminary data for the second quarter may understate actual income. A similar episode three years ago caused some concern about a low saving rate: but revisions in the data showed that saving had not in fact been particularly low.
- National income accounts income data do not reflect the recent capital gains in the stock market. These wealth increases may support higher consumption levels, and thus push down the saving rate.
- Capital gains in housing may also be supporting higher consumption. In the first quarter of 1983, the latest period for which information is available, homeowners as a group realized about $60 billion of equity in their existing homes by taking out mortgages. This was up from $30 billion in most of 1982. If the same phenomenon occurred in the second quarter of 1983, then the consumption growth may have been supported by the capital gains in housing that were made in the late 1970s, but which are only now being realized.
- Consumers may have simply anticipated the July 1983 tax cut. The reduction in the saving rate is worth abut $35 billion at an annual rate, close to the reduction in withholding in July.

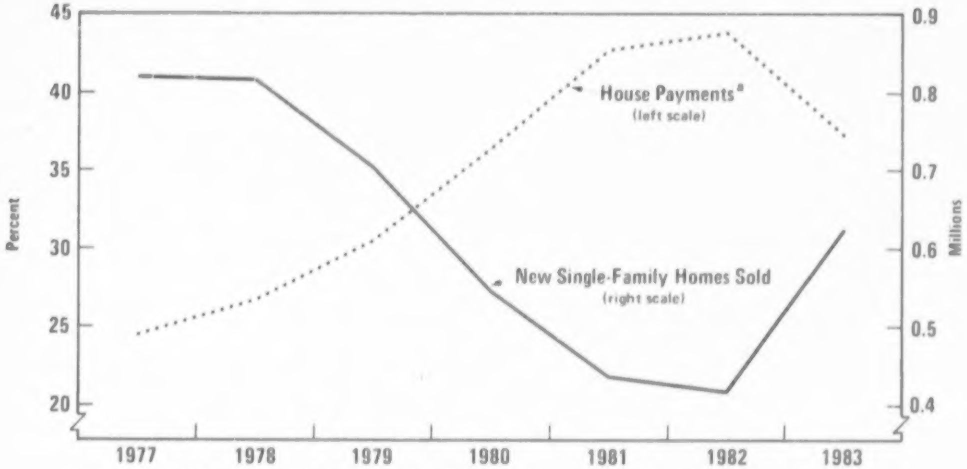
Housing

The housing industry showed perhaps the most dramatic early evidence of renewed strength in the economy. It had been depressed since 1979, when a combination of rising house prices and almost unprecedentedly high interest rates pushed new home purchase costs out of reach of many families.

The mortgage rate has now declined to about 12.6 percent from a high of 16.3 percent in November 1981, and house prices have not risen by very

Figure 12.

House Payments and Houses Sold



SOURCES: U.S. Department of Commerce, Bureaus of the Census and of Economic Analysis; Congressional Budget Office.

NOTE: 1983 values are for first half of the year.

[a] House payments, based on current mortgage rates and average price of houses sold, as percent of median family income.

much since 1979. 8/ Partly as a result, starts of new homes have increased from an annual rate of 1.0 million units last year to 1.7 million in June of this year. The number of new single-family houses sold has nearly doubled since mid-1982 (see Figure 12).

Household formation and the shortfall in additions to the housing stock in the past few years have created a backlog in demand for housing units. But other factors may prevent a return to the boom years of 1977-1978, when housing starts were around 2 million units:

o Mortgage interest rates have risen from about 9 percent in 1977-1978 to a current level of about 12.6 percent. While the current rate is considerably below rates that were prevalent in 1980-1981,

---

8/ Mortgage rates quoted are the effective rates on mortgage loans closed, as given by the Federal Home Loan Bank Board. Other frequently quoted rates, such as that for mortgage commitments or the secondary market rate for FHA mortgages, are often much higher.

it still implies mortgage payments about 30 percent higher than in 1978 for a mortgage of the same size.

- House prices in 1977-1978 were rising fast, and were widely expected to continue rising. Thus the real rate of interest on mortgages was much lower than the nominal rate, and was probably negative. Few people now expect a resumption of rapid increases in house prices.

Because of these two major changes, housebuilding may not consistently reach or exceed the levels of 1978-1979. Recent increases in mortgage rates suggest that further increases in homebuilding may be small.

Businesses

Business failures are at postwar record levels (see Figure 13). The high rate of failures is the result not only of the most severe postwar recession, but also of exceptionally high real interest rates. Businesses responded to high long-term interest rates and a depressed stock market by reducing the share of capital financed by long-term debt and by equity. This avoided locking in high capital costs for the long run, and has enabled corporations to take advantage of falling short-term interest rates and a rising stock market over the past year. But it has left them vulnerable to increases in interest rates, which could quickly increase their debt-service costs.

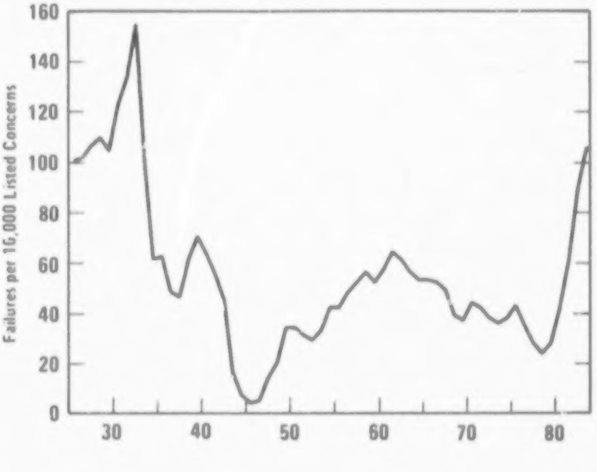


Figure 13.
Business Failure Rate

SOURCE: Dun and Bradstreet.
NOTE: 1983 data are for the first half of the year.

Corporate profits (after adjustment for the effects of tax law on depreciation allowances) rose 12 percent in the first quarter of 1983, and probably have increased sharply again in the second quarter. The profit increases stem from cyclical improvements in productivity, from the deceleration of wages--which has been much larger than in previous recessions--and from lower interest costs. First-quarter profits of oil refiners were also pushed up by the decline in crude oil prices.

Recent changes in tax law, too, have increased the internal funds available to corporations for investment, reducing their need to go to debt and equity markets. The depreciation and other changes in the Economic Recovery Tax Act of 1981 (ERTA), modified in 1982, cut corporate taxes by about $9 billion in 1982, and are expected to reduce them by about $7 billion in 1983.

The conditions are thus in place for an expansion in investment activity, provided that the state of demand permits it and provided that interest rates do not rise again significantly. The June survey of investment anticipations by the Commerce Department suggests an increase of about 6 percent in plant and equipment spending between the fourth quarters of 1982 and 1983. This would be a somewhat slower rate of increase than in previous cyclical upturns, but the survey usually understates actual spending as reported in the National Income Accounts at the beginning of recoveries. With prices for capital goods expected to be stable, the anticipations survey would imply a similar percentage increase in real spending.

Nonresidential construction usually declines for about a year after the beginning of an upturn in economic activity. The lag is likely to be longer than usual this time, for two reasons:

- The extraordinary current level of real interest rates has a much heavier impact on long-lived construction investment than on shorter-lived investment. These high rates probably more than offset the more favorable treatment accorded to structures investment in ERTA.

- Business construction was supported during the recession by an office building boom. This boom has now ended, office vacancy rates are high, and office construction is likely to continue to fall off.

Equipment purchases, unlike business construction, generally turn up promptly with a recovery in economic activity. Spending on producers' durable equipment rose at a 9.4 percent annual rate in the first half of 1983, one of the strongest recoveries in investment in the postwar period.

Shipments and new orders for nondefense capital goods have increased a little and the order backlog has risen for the first time in two years.

Net Exports

Net exports of goods and services in the second quarter showed a deficit of $12.5 billion at annual rates, the first deficit in this balance since 1978. A downward trend in the external accounts of the United States had been clear for some time. In terms of 1972 dollars, the net export balance declined from over $53 billion at an annual rate in mid-1980 to $23.0 billion in the fourth quarter of last year. Since then, it has dropped further to $10.2 billion for the second quarter of this year. The deterioration was particularly dramatic in the merchandise trade balance, now averaging deficits of more than $70 billion dollars at annual rates. The record trade deficits account for as much as a 1½ percent loss in real GNP over the last three years, and are expected to be a drag on the domestic economy this year as the recovery gathers steam.

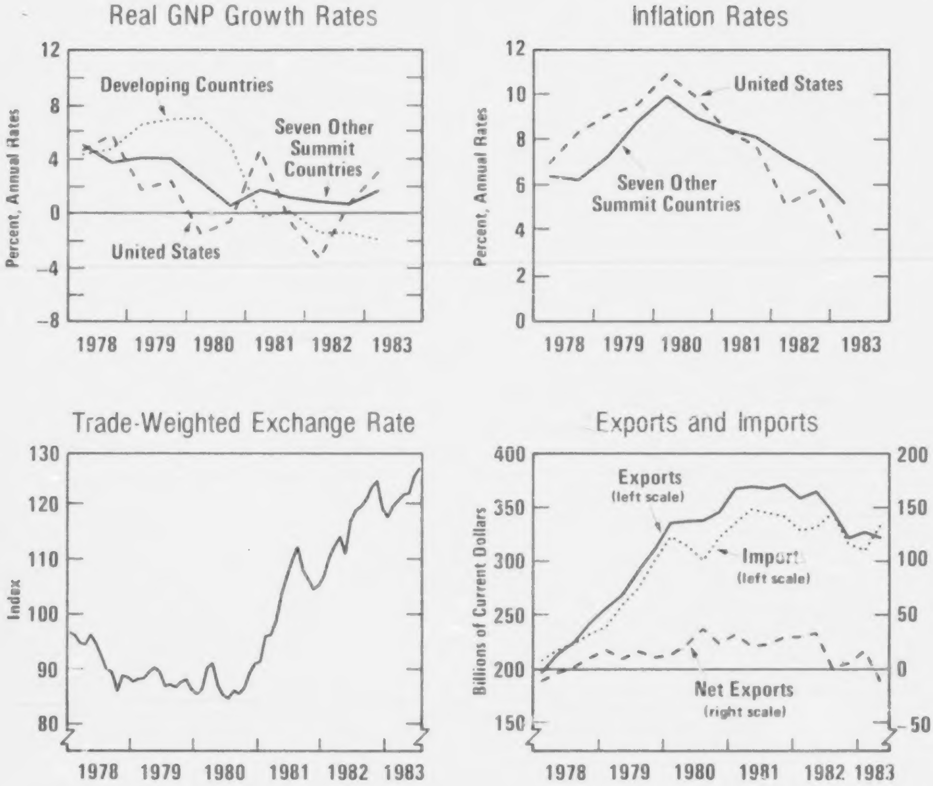
Net exports usually improve during a recession, which tends to cut imports. But the severity of the recession abroad cut demand for U.S. exports, and the high dollar exchange rate kept export prices uncompetitively high and import prices abnormally low during the recession. Thus, while merchandise exports fell $46.7 billion from mid-1981 to the end of last year, merchandise imports dropped only $30.7 billion.

It is likely that recovery will bring further worsening of net exports. So far, only the U.S. economy has shown any real signs of strong recovery (see Figure 14). Not only are the main U.S. trading partners lagging behind, but many debt-burdened developing countries are still experiencing economic contraction. At present it appears likely that there will be no significant recovery for the main trading partners until late this year, and whatever recovery does occur will be less than normal. The Organization for Economic Cooperation and Development, in its annual forecast report, expects a modest 2.0 percent real growth rate for the largest U.S. trading partners in the second half of 1983, and a 2.4 percent growth rate for 1984—a full percentage point below average growth rates in the 1970s. Progress by developing countries in rescheduling their international debts has been made possible through stringent austerity measures coupled with sharp cutbacks in their imports. Since those countries account for about a third of U.S. exports, and the OECD countries account for most of the rest, the outlook for exports is poor. In the meantime, growing U.S. demand will further increase imports.

Improvement in the international trade sector of the economy will be slow. The continuing high value of the dollar means that imports remain

Figure 14.

Determinants of Net Exports



Real GNP Growth Rates

Inflation Rates

Trade-Weighted Exchange Rate

Exports and Imports

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Organization for Economic Cooperation and Development; Federal Reserve Board.

relatively more attractive to U.S. consumers while U.S. goods and services are relatively dear to foreigners. Moreover, U.S. firms have lost export markets that will take some time to recoup because of the time required for international contractual and marketing arrangements. Consequently, even if the dollar does depreciate to more appropriate levels, lags in the response of trade flows to exchange rate changes imply that any improvement is at least a year away.

THE MAKEUP OF THE TRADE DECLINE

The merchandise trade balance deteriorated dramatically during the course of the recession. Exports declined by $46.7 billion. Imports declined as well with about three quarters of the drop of $30.7 billion attributable to decreased imports of petroleum and products. Oil imports continued to decline through March, but have since risen sharply, contributing along with increased auto imports to a merchandise trade deficit of $71 billion at an annual rate in May and June.

	Before the Recession 1981:2	End of Recession 1982:4	Difference
Merchandise Exports (current dollars)			
Food, Feeds, Beverages	37.9	27.3	-10.6
Industrial Supplies, Materials	65.6	57.7	-7.9
Capital Goods (except automotive)	83.0	66.5	-16.5
Automotive	19.8	13.5	-6.3
Consumer Goods (nonfood)	16.1	13.8	-2.3
Other	17.7	14.6	-3.1
Total	240.1	193.4	-46.7
Merchandise Imports (current dollars)			
Foods, Feeds, Beverages	18.2	17.7	-0.5
Industrial Supplies, Materials (nonpetroleum)	54.4	45.3	-9.1
Petroleum and products	83.2	60.5	-22.7
Capital Goods (except automotive)	35.4	34.4	-1.0
Automotive	30.9	31.3	0.4
Consumer Goods (nonfood)	37.4	39.0	1.6
Other	10.0	10.6	0.6
Total	269.5	238.8	-30.7
Merchandise Balance	-29.4	-45.4	-16.0
Net Exports of Goods and Services			
In current dollars	21.1	5.6	-15.5
In 1972 dollars	44.1	23.0	-21.1

CHAPTER III. MONETARY AND FISCAL POLICY

The current recovery owes much to the significant easing of monetary policy that occurred last summer and to the expansive fiscal policy. Nevertheless, real interest rates—those adjusted for inflation—remain stubbornly high, and now threaten to move still higher, especially if measures to reduce deficits are not enacted. As a result, there is risk that high interest rates will stall the recovery in housing and weaken other sectors after only a few quarters. Equally serious is the longer-term danger that persistently high real interest rates will depress the level of investment below the pattern that is typical in recoveries, holding down growth in productivity and per capita income.

It is not hard to find reasons for the persistence of high rates in the recent and prospective behavior of monetary and fiscal policies. High and rising federal deficits, strong money demand, and indecision on the part of policymakers about what to do in these conditions may all contribute to holding up rates. This chapter describes recent developments in financial and budget conditions and the problems for policy.

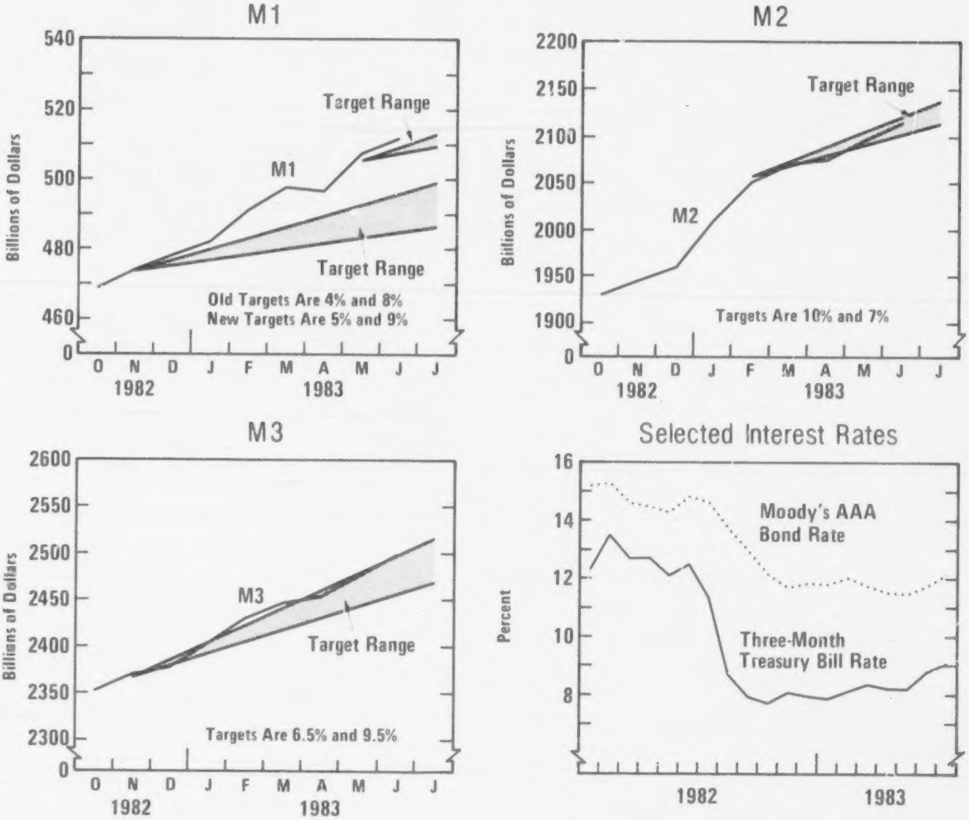
MONETARY POLICY AND FINANCIAL CONDITIONS

Events in the financial sector have complicated the analyst's work. Strong growth in the monetary aggregates has raised fears of future inflation, and evoked calls for monetary restraint. On the other hand, real interest rates have remained high despite the rapid growth in the money supply.

The combination of rapid money expansion and high real interest rates is unusual. It may reflect several factors: the possibility that federal deficits will crowd out private borrowing; the fact that the recovery is strong; the effects of volatility in financial markets; and/or a tendency of the public to hold more of its assets in the form of money. To the extent that the latter factor is important—that there has been a permanent increase in the demand for money—the fears of inflation may prove unfounded, since the additional money will not contribute to a demand for goods. The remainder of this section will review the data on the monetary aggregates and assess the role of the Federal Reserve's current monetary policy.

Figure 15.

Monetary Targets and Selected Interest Rates



SOURCE: Federal Reserve Board.

NOTE: M1, M2, and M3 are alternative measures of money supply. M1 consists of items, such as currency and demand deposits, considered likely to be used for financing current purchases. M2 and M3 include items more likely to be held as financial assets, such as savings deposits. Specifically, M1 consists of currency in circulation, travelers' checks, checking accounts, and other checkable deposits at depository institutions. M2 consists of M1 plus savings and small time deposits at depository institutions, money market mutual fund shares, and some overnight repurchase agreements and Eurodollar deposits. M3 is M2 plus large time deposits, term repurchase agreements, and institution-only money market mutual fund balances.

Monetary Targets and Velocity

In February, the Federal Reserve Board announced new monetary targets that it believed would promote a moderate and sustainable recovery without reigniting inflation (see Figure 15). Although the new target ranges are somewhat higher than last year's, the Federal Reserve stated that recent changes in the financial system—including but not limited to the advent of new deposit instruments—meant that the new targets actually called for somewhat slower "effective" growth in the aggregates. (Since inflation is expected to be lower this year than last, real growth in the money supply may nevertheless be the same or higher.) Moreover, the central bank announced that it would emphasize the behavior of the broader aggregates M2 and M3, and that the base for the M2 target would be the February/March average rather than that of the fourth quarter of the previous year as is customary. 1/ The deemphasis of Ml and the rebasing of the M2 growth targets were seen as evidence of a more flexible approach, one that relies more heavily on judgment in setting target ranges and in interpreting movements in the aggregates relative to these ranges.

The behavior of the monetary aggregates in the first six months of 1983 confirms this increased flexibility. Ml continued to expand very rapidly—14.6 percent at an annual rate from December through June—and at the end of the period stood well above the target range established in February. M2 and M3 also exhibited robust growth and are currently near their respective upper target limits. The rapid money growth, especially in Ml, prompted fears in the financial markets that the Federal Reserve would be forced to tighten up. In July, however, it stated in its midyear policy report that, although it had been somewhat less accommodative in recent weeks, the markets should not expect the degree of tightening necessary to

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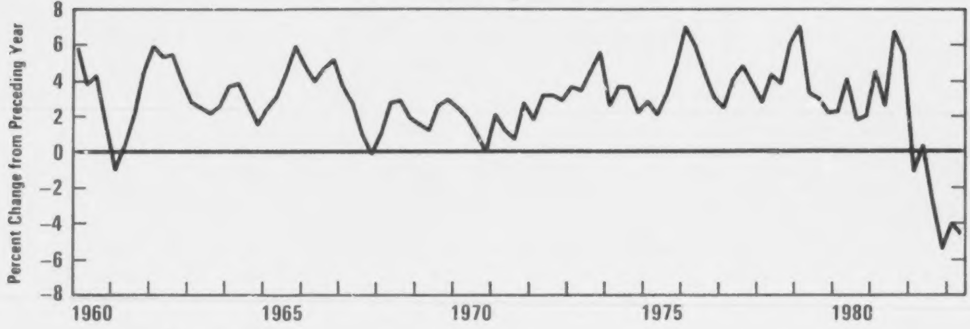
1/ The rebasing of M2 was a direct attempt to offset the anticipated effect of the new deposit instruments authorized in December and January. A Federal Reserve study indicated that the new instruments had a marked effect on M2, but a much smaller impact on Ml and M3. This occurred because money market deposit accounts (MMDAs), authorized last December and included in M2, attracted a significant amount of funds from sources outside of M2—preliminary estimates place this figure as high as $70 billion. By contrast, the new instruments have had only a minimal effect on Ml, because inflows to super-NOW accounts, which are included in Ml, have come primarily from other Ml components or have been offset by outflows from Ml into new instruments, such as MMDAs, that are not in Ml. M3 is also thought to be only minimally affected because most of the funds flowing into either of the new deposit categories came from, or were offset by, funds already in M3.

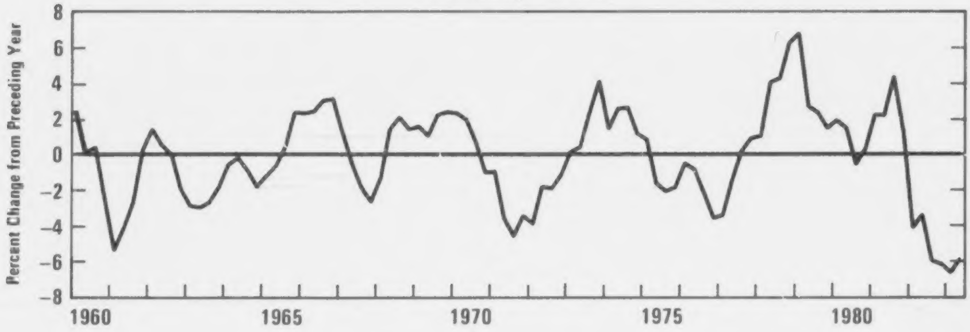
Figure 16.

Growth in Velocity of Money Aggregates

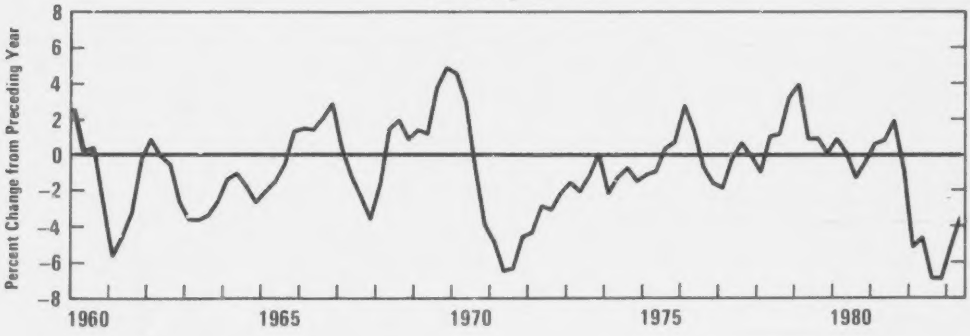
Velocity of M1



Velocity of M2



Velocity of M3



SOURCE: Congressional Budget Office.

return M1 to its February target range. Because the broader aggregates were within their target ranges and M1 growth was beginning to decelerate, severe tightening did not seem warranted, according to the central bank.

To reinforce this point, it raised the M1 targets to a range of 5 to 9 percent, and changed the base to the second-quarter 1983 average. The change in base period reflects the central bank's view that the relationship between M1 and GNP has changed. Because a significant portion of current money growth may finance accumulations of balances held as financial investments, rather than for making purchases, it held that the more rapid M1 growth witnessed earlier in the year was not excessive. Since the introduction of the new targets, however, M1 growth has exceeded even these higher levels.

The consequences of a given money growth rate ultimately depend upon the behavior of the demand for money, which is reflected in monetary velocity. Velocity—the ratio of GNP to money—measures the number of times on average that each dollar is used during the year in a transaction included in GNP. If the growth rate of velocity drops, more money growth is required to achieve a given GNP growth rate. As Figure 16 shows, all measures of velocity growth dropped precipitously during the recession. M1 velocity growth fell to negative levels for the first time in almost 20 years. The declines in the growth rates of M2 velocity (V2) and M3 velocity (V3), while not rare occurrences, were somewhat steeper and more prolonged than any in the last decade. This behavior implies that recent money growth has served to finance accumulations of idle balances rather than contributing to concurrent growth of GNP.

The decline in velocity has been particularly anomalous because this measure normally rebounds sharply in the first few months of an economic recovery, growing well above its long-run trend (see Table 10). Not only is current velocity growth lower than normal, however; it is also well below trend. 2/ This has led many economists to suspect that the amount of money that households and firms wish to hold for a given level of GNP has shifted upward significantly, perhaps in response to a reduction in inflationary expectations. There is good reason to expect that the demand for money increases when inflation is expected to decline: money retains

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2/ The advent of new instruments—especially the money market deposit account—appears to have contributed to the decline in velocity. However, the decline started well before the new instruments and is still evident after adjusting the data for growth in the new accounts. Moreover, the new instruments apparently had only minor impacts on M1 and M3.

TABLE 10. VELOCITY GROWTH FOLLOWING CYCLICAL TROUGHS

Number of Quarters Since Trough	V1		V2		V3	
	Historical Average a/	Current Recovery	Historical Average a/	Current Recovery	Historical Average a/	Current Recovery
One	5.9	-6.0	1.3	-11.0 b/	1.0	-2.2
Two	6.7	-2.7	1.3	-4.8	1.2	1.2
Three	5.2		0.7		0.5	
Four	5.5		0.4		0.2	
1960 to 1982 TREND	2.9		0.1		-0.7	

a/ Data represent averages of the four previous recoveries.

b/ M2 has been distorted by the introduction of money market deposit accounts. If the additional M2 growth attributed to these accounts was removed, the corresponding velocity growth would be -1.8 percent and 1.7 percent for the first quarter and half year of the current recovery.

more of its purchasing power when inflation is low, so the cost of holding money is lower. If moneyholders' expectations are still adjusting to the recent declines in the inflation rate, this could do much to explain the recent behavior of velocity. If so, velocity may not snap back to its former level, but rather may begin growing at its old trend rate once the adjustment in inflationary expectations is completed. In that case, recent money growth would not be inflationary, and only a moderate slowdown in future money growth would be needed.

Other economists, who believe that velocity is stable over long periods, contend that the relationship between money and income has been disturbed not by inflationary expectations, but rather by a cyclical increase in money demand related most directly to the recession. Since we are now in a strong recovery, they expect velocity to rebound in the near future. If so, continued growth in money at current rates would eventually lead to inflationary pressures. 3/ The monetary prescription suggested by this group

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3/ This view found some support in a Federal Reserve study suggesting that the decline in velocity was due to increased precautionary money demand in the wake of rising unemployment. Improvement on the unemployment scene should therefore trigger a reduction in money calls for a marked slowdown in money growth as soon as velocity begins growing again.

A third view of the causes of the recent slowdown in velocity emphasizes the time lags that often occur between changes in the money supply and changes in GNP. GNP may not yet have had time to increase proportionally with recent strong increases in the money supply. If this is true, velocity growth may return to more normal levels once a period of adjustment has passed.

The difficulty of resolving this issue is shown by Figure 17, which depicts movements in velocity since 1960 relative to its trend levels. Although the graphs show considerable short-run volatility, the various measures of velocity appear to be stable in the longer run around their respective long-run trends. This has been used to support the hypothesis that velocity will grow rapidly in the near term in order to return to its trend. If it does, then current money growth, if unchecked, may prove to be inflationary. But the graphs also show periods as long as five years during which the respective velocities were either above or below their trend levels. If the present is one of these below-trend periods, a snapback may not be imminent and fairly rapid growth in money may not be inflationary. The behavior of velocity remains one of the key uncertainties in the present and future conduct of monetary policy.

Recent Behavior of Interest Rates

Interest rates dropped sharply last summer and fall, but have recently moved upward slightly, and remain high for this phase of the business cycle (see Figure 18). Among the causes that have been suggested are:

- o Expectations of future inflation, which raise nominal long-term rates;
- o Continued fears that large federal deficits may conflict with increasing private credit demands and raise real rates;

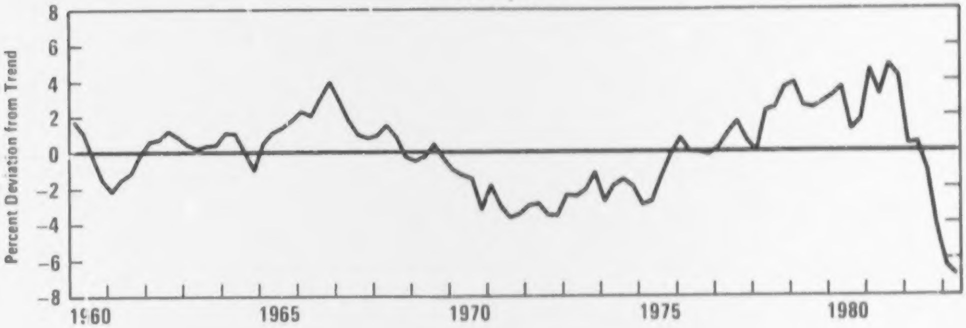
3/ (Continued)

balances and a rebound in velocity. However, current data that show an improvement in unemployment and overall economic conditions, together with declining velocity, seem to argue the contrary.

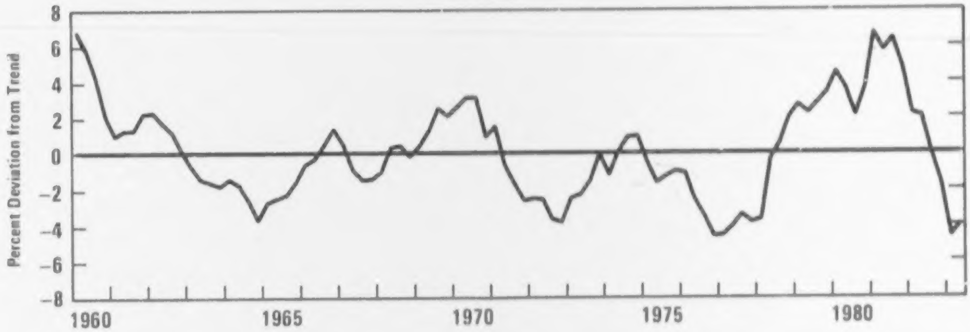
Figure 17.

Deviations from Trend of Velocity of Money Aggregates

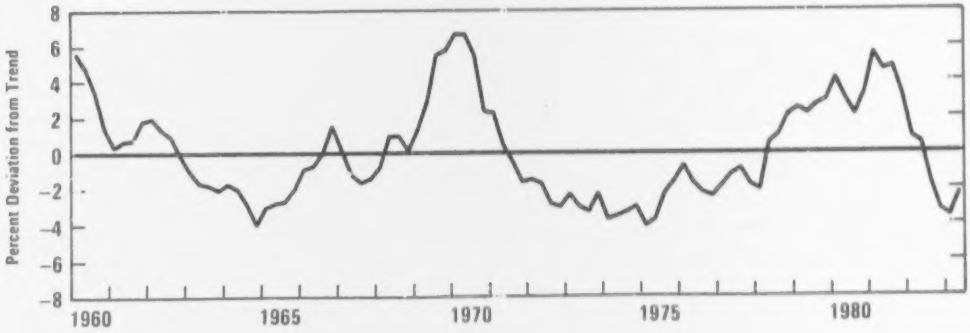
Velocity of M1



Velocity of M2



Velocity of M3



SOURCE: Congressional Budget Office.

- The expectation that monetary policy may be restrictive in future years;
- Lingering uncertainty over whether and by how much policymakers will ultimately change budget deficits and monetary policy (this factor is discussed later in the chapter);
- Additional uncertainty about financial conditions stemming from recent volatility in money growth rates and interest rates;
- The belief that monetary policy has failed to accommodate fully a shift in the demand for money, which also would tend to raise both nominal and real short-term interest rates.

It is possible that several of these factors have contributed to the persistently high levels of interest rates in the last six months. Some of the most important of these arguments are discussed below.

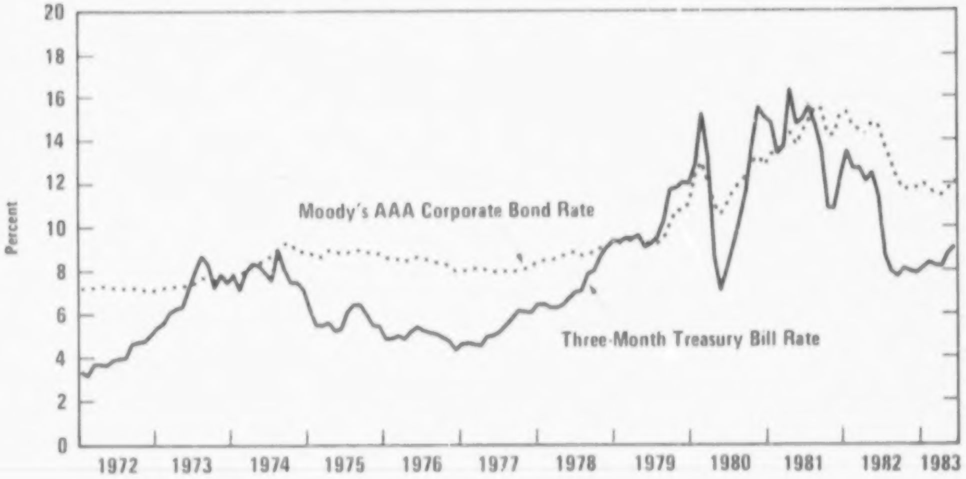
Inflationary Expectations. Analysts who look to expectations of inflation as the preeminent reason for current high interest rates offer two possible explanations. One is that inflationary expectations are changed slowly and have not yet fully embodied the recent improvements in prices. The other is that they stem from recent rapid money growth coupled with uncertainty as to whether the Federal Reserve will slow this growth in the future. The first explanation suggests that inflationary expectations and interest rates should continue to decline as the public becomes more accustomed to lower inflation rates. The second explanation is consistent with continued expectations of price increases and higher interest rates, especially if strong money growth continues and monetary policy remains unclear. However, both explanations are relevant only to longer-term rates; they do little to explain why short-term rates have been slow to fall.

Government Deficits. Many observers believe that a principal cause of today's seemingly high real interest rates is the expectation of very high federal deficits in the future. These deficits can be expected to increase future short-term real rates by intensifying the bidding for available funds. Since current long-term real interest rates are determined in part by expected future real short-term rates, this factor could do much to explain the current levels of rates. The argument is hard to verify statistically, however. One reason is that real interest rates are hard to measure, since doing so requires subtracting from observed interest rates an unobservable magnitude—the expected rate of inflation. A second difficulty in verifying the theory is that it may not have held during most previous years from which the available data are drawn. Before 1980, the Federal Reserve may have prevented deficits from raising short-term rates by "monetizing"

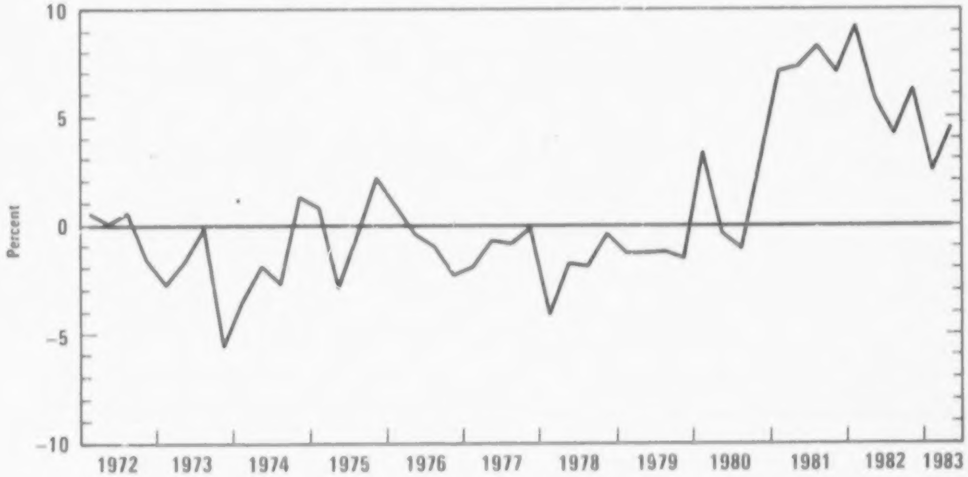
Figure 18.

Selected Interest Rate Measures

Short-Term and Long-Term Nominal Rates



Real Short-Term Rates: Three-Month Treasury Bills



SOURCE: Federal Reserve Board; Congressional Budget Office.

NOTE: Real rates are nominal rates adjusted for inflation in the succeeding three months.

them. 4/ Both crowding out and monetization are discussed at greater length later in this chapter.

Future Monetary Policy. Some analysts expect Federal Reserve policy to be restrictive for several years in an effort to control inflation. This too implies that current long-term rates may be high because future short-term rates are expected to be high.

Shifts in Money Demand. Other economists have attributed the high interest rates to the Federal Reserve's failure to accommodate fully an increase in the demand for money. In previous reports, CBO has included simulations from standard money demand functions that provide evidence that an upward shift in demand has occurred. Failure to accommodate fully such an increase in demand would result in higher-than-normal real interest rates. An update of these results through the most recent quarter indicates an underprediction of as much as $30 billion or roughly 6 percent of M1. 5/ As a result, interest rates may have remained higher than otherwise would have been expected.

Whatever the reason for the high rates, it is somewhat surprising that the recovery in housing—a sector that is especially sensitive to interest rates—has been as strong as recent data indicate. Some of that rebound may be due to the release of pent-up demand when rates fell, and continued high real rates may inhibit further growth in those industries. Higher rates could also weigh heavily on the interest-sensitive investment sector as the recovery continues.

The Current Outlook for Monetary Policy

Entering the third quarter of the recovery, the Federal Reserve faces a dilemma. An attempt to slow the growth of money in the face of people's desire to hold more of it could raise already high interest rates and

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4/ For evidence in this regard, see Michael Hamburger and Burton Zwick, "Deficits, Money, and Inflation," Journal of Monetary Economics, vol. 7, no. 1 (January 1981); and Mickey D. Levy, "Factors Affecting Monetary Policy in an Era of Inflation," Journal of Monetary Economics, vol. 8, no. 3 (November 1981).

5/ These estimates were derived from dynamic simulations of money demand functions estimated through the fourth quarter of 1981. The computations are described in Congressional Budget Office, The Economic and Budget Outlook: An Update (September 1982).

adversely affect the recovery. High rates in the U.S. also make it more difficult for less-developed countries to refinance their external debts, a factor that may severely constrain the Fed's policy options. But continued rapid monetary expansion, if velocity growth increased, could mean a resurgence of inflationary expectations, higher nominal interest rates, and after some delay, increases in wage inflation.

In this quandary the Federal Reserve appears to be steering a middle course, though it is not clear what indicators it will rely on. Last September CBO outlined the pros and cons of policy indicators such as nominal GNP or interest rates. 6/ It assumed that the Federal Reserve would continue to announce a target range for the money aggregates but would be more flexible in setting the appropriate target range relative to changes in money demand (or equivalently, velocity). This assumption is still appropriate. In February, the central bank announced targets that not only accommodated money growth due to financial innovation but also allowed for slower-than-normal velocity growth. In its midyear report, the bank reaffirmed its growth ranges for the broader aggregates and retargeted M1 to accommodate the decline in velocity that occurred earlier in the year. Thus the Fed appears to be leaning toward promoting recovery, taking a somewhat greater risk of renewed inflation.

While increased flexibility may be necessary to offset the movements in velocity, this posture runs the risk of reducing the Federal Reserve's credibility as an inflation fighter. Erosion in credibility tends to increase inflationary expectations and market uncertainty, both of which put pressure on interest rates. In its midyear report the central bank reaffirmed its commitment to maintaining sustainable growth in the economy without increases in inflation. Still, the financial markets may have a different perception. Some economists believe that the bank would increase its credibility if it set goals for nominal GNP along with its monetary-aggregate targets.

FISCAL POLICY

The federal deficit has increased dramatically over the past two years, and is projected to remain at very high levels unless current policies are changed (see Table 11). The CBO baseline budget estimates, which exclude the effects of the First Budget Resolution for Fiscal Year 1984, show budget deficits in the neighborhood of $200 billion through 1986. If the policies of the resolution are put into effect, however, the deficit would decline by about $60 billion from 1983 to 1986.

6/ Ibid.

TABLE 11. UNIFIED BUDGET DEFICITS (By Fiscal Year)

	Actual	Estimate	CBO Projection		
	1982	1983	1984	1985	1986
		In Billions of Dollars			
February 1983 Baseline	111	194	197	214	231
August 1983 Baseline		207	196	205	214
Budget Resolution Policies including Reserve		207	192	180	146
Budget Resolution Policies excluding Reserve		207	183	176	143
		As a Percent of GNP a/			
February 1983 Baseline	3.6	6.1	5.6	5.6	5.6
August 1983 Baseline		6.4	5.5	5.3	5.1
Budget Resolution Policies including Reserve		6.4	5.4	4.6	3.5
Budget Resolution Policies excluding Reserve		6.4	5.1	4.5	3.4

a/ Reserve fund does not significantly affect budget figures when expressed as percent of GNP.

NOTE: For a detailed description of the February 1983 baseline estimates see CBO, Baseline Budget Projections for Fiscal Years 1984-1988, February 1983. For further details on the August 1983 baseline budget estimates see Appendix A of this report.

The recession widened the deficit by reducing tax revenues and increasing outlays for such programs as unemployment compensation. But the deficit would be very large even if there had been no recession and would tend to grow larger under current tax laws and spending policies. These developments are reflected in estimates of the structural deficit (that is, the part of the deficit that does not result from recession.) One such measure is the Standardized-Employment Deficit, the deficit as it would look if the unemployment rate were held to a relatively low rate of 6.0 percent.

Last February CBO estimated that the Standardized-Employment Deficit would rise steadily from 0.9 percent of cyclically-adjusted GNP in

TABLE 12. STANDARDIZED-EMPLOYMENT DEFICITS a/

	Actual	Estimate	Projection		
	1982	1983	1984	1985	1986
		In Billions of Dollars			
February 1983 estimate b/	29	69	91	128	159
August 1983 estimate c/	29	97	99	110	87
		As a Percent of Cyclically-Adjusted GNP			
February 1983 estimate	0.9	2.0	2.4	3.1	3.6
August 1983 estimate	0.9	2.8	2.6	2.7	2.0

a/ Unified budget estimate standardized at 6 percent unemployment. The estimates exclude the reserve fund. The programs included in the reserve fund would cost $9 billion in fiscal year 1984, $5 billion in 1985, and $4 billion in 1986. The impacts at the 6 percent unemployment rate that underlies the Standardized-Employment Deficit would be less.

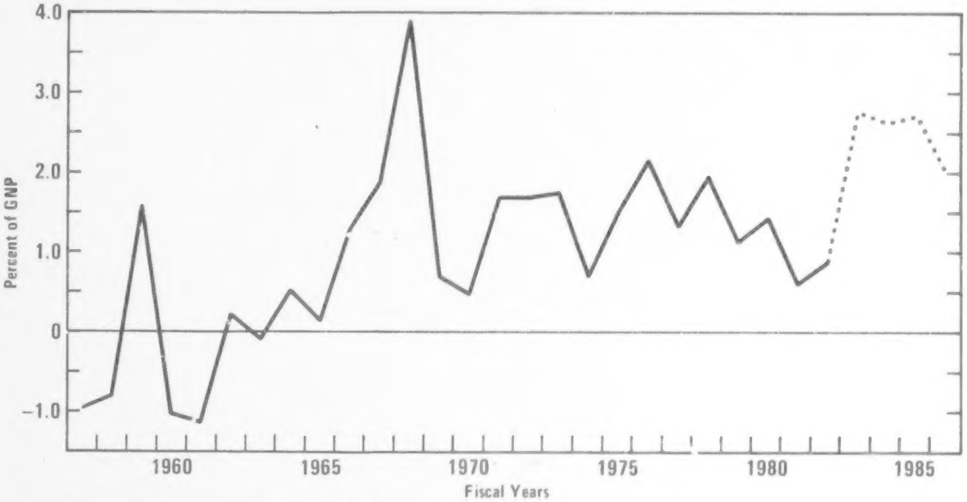
b/ Congressional Budget Office, The Outlook For Economic Recovery (February 1983). The 1982 levels have been revised to reflect revisions in economic data for that year.

c/ Assumes policies of First Budget Resolution for Fiscal Year 1984 passed last June.

fiscal year 1982 to 3.6 percent in 1986 under the policies then in place. Under some circumstances, such increases in the structural deficit could temporarily help stimulate a depressed economy. Over the long term, however, such large structural deficit levels can cause serious problems for the economy, as this discussion will point out. Faced with this prospect, the Congress has responded by passing a plan that would curtail structural deficits. The policies of the First Concurrent Resolution on the Budget for Fiscal Year 1984 would reduce the structural deficit significantly after 1984

Figure 19.

Standardized Budget Deficit as a Percentage of Standardized Gross National Product



SOURCE: Congressional Budget Office.

NOTE: Standardized at 6 percent unemployment.

while preserving its stimulus in the near term, as Table 12 shows. 7/ By 1986, the Standardized-Employment Deficit would decline to 2.0 percent of GNP with these policies. Nevertheless, this measure of the deficit would still be very large--far above the average of 1 percent of cyclically-adjusted GNP that has been observed since the late 1950s (see Figure 19).

Moreover, there are still reasons to be concerned that the policies of the First Resolution will not be implemented. The further legislation that is needed is embroiled in controversy, and the eventual outcome is highly uncertain. The budget outlined in the Resolution differs significantly from the President's proposal. Many members of Congress have suggested that the Congress may be unwilling to increase revenues as much as is called for

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7/ Current estimates of the Standardized-Employment Deficit for fiscal years 1983 and 1984 now actually exceed last February's figures, largely because of increased interest cost estimates and a variety of technical reestimates to revenues and outlays.

in the Resolution. The unusual degree of uncertainty over the deficit outcome may be reflected in current high interest rates. [8]

What Is Wrong with Large Structural Deficits?

Large budget deficits are not bad in all circumstances. When the economy is in recession, cyclical or structural increases in the deficit can bolster incomes and employment, mitigating the recession's severity, provided they are not offset by monetary policy.

The current deficit may be stimulating recovery substantially, since the Federal Reserve may not be following a monetary-targeting system. The projection of increasing deficits over the 1982 to 1984 period is a major reason for CBO's forecast of a recovery.

Large structural budget deficits may have serious economic consequences, however, particularly if they persist in the face of strong private demands. Under moderate Federal Reserve money growth policies, strong government and business credit demands would result in high real interest rates as government demand for credit absorbed a large share of the economy's savings, diverting or "crowding out" these funds from private capital markets. To the extent that business capital spending was discouraged, the ultimate effect would be a reduction in productivity and living standards.

If, on the other hand, the Fed tried to hold down real interest rates and help finance the larger deficits by converting a significant share of the Treasury's new debt into money, or "monetizing" it, the ultimate outcome might be an accelerating inflation as well as reductions in investment and productivity growth. The large prospective deficits, which are due largely to rising interest outlays, make the prospect of monetization seem more likely. Crowding out and debt monetization, then, are the major ways in which deficits threaten to affect the economy.

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[8] Financial assets may become less attractive to investors who dislike risk if the uncertainty surrounding the budget outcome increases. This may be true even if the particular budget outcome that these investors consider most likely does not change. This is because financial markets increase the expected real yield on risky securities relative to that on safe ones by enough to compensate risk-averse investors for uncertainty. This increase in expected yield is called the "risk premium."

How Much Crowding Out Do Deficits Cause?

It would be easy to overestimate the amount of productive investment that a given deficit is likely to displace, even under a "tight" monetary policy. This is because:

- Changes in tax provisions or spending programs that increase deficits may also increase private saving.
- Increases in real interest rates that accompany large deficits attract foreign capital.
- Crowding out may affect investment in housing and other types of spending more strongly than business investment because the latter may be determined primarily by the strength of overall demand, rather than by interest rates. If so, the consequences for productivity may be less severe than they would if business investment were more heavily affected.

Savings Impacts of Budget Programs. Many of the particular changes in tax provisions and spending that underlie recent increases in structural deficits may also temporarily increase corporate and personal saving rates. The more liberal 1981 provisions governing tax deductions for depreciation of business capital, for example, entailed a large revenue loss even after they were scaled back in 1982. The reduced business tax liabilities deriving from this legislation should lessen the amount of near-term business borrowing to finance any given investment; thus it may temporarily increase business saving at the same time that it increases government borrowing.

There are several ways in which personal savings, too, may be affected by current budget deficits. The recent cuts in marginal personal income tax rates and enactment of tax provisons for Individual Retirement Accounts and Keogh Plans, all of which increase the deficit significantly, may also increase personal saving rates, at least temporarily. The saving rate may also be increased by the growing share of the deficit that is accounted for by interest outlays. A large part of these outlays occurs because nominal interest rates contain a premium to compensate bondholders for expected inflation. Interest outlays that reflect this premium may be saved by bondholders, since such saving is necessary to prevent the real value of their wealth from being eroded by inflation. Increases in interest outlays that reflect rising real interest rates may also be associated with increases in the personal saving rate, since there is some evidence that saving responds to changes in interest rates.

These savings impacts, if they are significant, should be reflected in observed saving rates in the absence of offsetting impacts from other factors. As Chapter II has shown, however, the measured personal saving rate has recently fallen to very low levels by historical standards. Thus, there is as yet little direct evidence that these savings impacts are occurring, though it is possible that their effects are being masked by other factors serving to depress the overall rate.

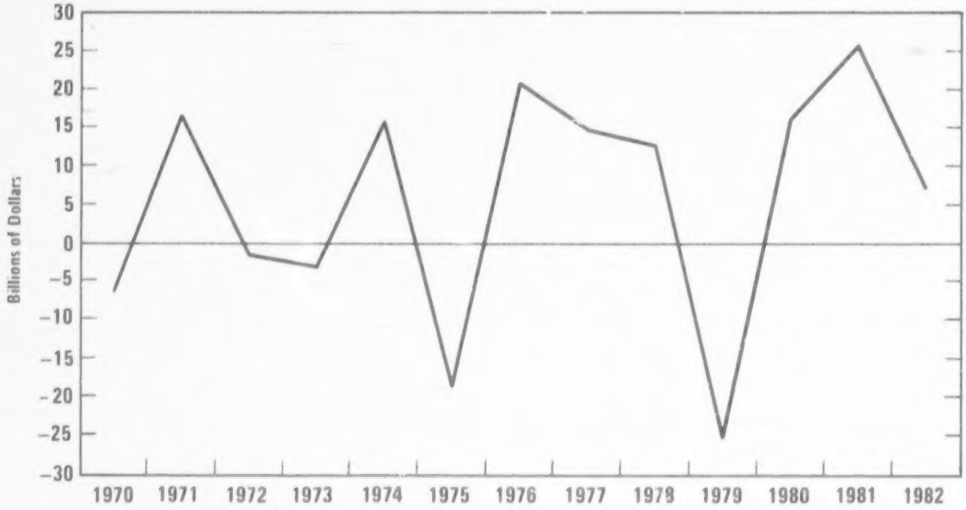
A different short-run savings impact, one that changes the total quantity of saving without necessarily affecting the saving rate, can occur in response to increases in the deficit itself if they stimulate an expansion in GNP. As this discussion has already suggested, budget deficits may increase economic activity if monetary aggregates are not controlled tightly. Such increases in overall income give rise to new savings flows, and this lessens the competition between government and private borrowing.

Foreign Financing of U.S. Deficits. Because U.S. interest rates have recently been high relative to those in other countries, significant amounts of foreign saving have been flowing into the United States. As Figure 20 shows, the increase in net foreign-owned assets reached $26 billion during 1981, and was still $7 billion in 1982 despite lower U.S. interest rates. While such inflows augment the flow of funds available for financing both the budget deficit and private investment, they also have negative impacts. Such capital flows are quite volatile and may reverse direction if economic conditions change. The inflow of foreign capital may also raise interest rates abroad, causing political as well as economic difficulties there; indeed, such inflows reduce crowding-out of U.S. investment largely by transferring the impact to other countries. Private capital inflows also tend to raise the exchange rate of the U.S. dollar (if central banks do not intervene), causing reductions in U.S. exports, increases in imports, and costly shifts of displaced resources into other sectors.

What Spending Is Crowded Out? Even if some crowding out is occurring, it may affect types of spending other than business investment. As the discussion above points out, for example, foreign capital inflows may protect investment from a shortfall in financing, but ultimately only at the cost of reductions in net exports instead. State and local government spending, housing, or consumer spending, all of which are sensitive to interest rates, may likewise be affected instead of private business investment, which may respond more strongly to overall demand than to interest rates. This possibility is accentuated by the fact that recent budget policy changes increased incentives to invest funds in business capital instead of housing and consumer durables. The acceleration of depreciation schedules and the reductions in individual income tax rates under the Economic Recovery Tax Act of 1981, in particular, reduced the overall cost

Figure 20.

Change in Net Foreign Assets in the United States



SOURCE: U.S. Department of Commerce.

NOTE: Figures represent year-to-year change in foreign holdings of U.S. assets.

of business capital at given levels of interest rates and at the same time reduced the relative value of tax preferences for housing. 9/

Monetization

Large deficits may be "monetized" if the Federal Reserve buys large quantities of new Treasury debt issues itself, thus converting them into bank reserves and therefore into sharp increases in the money supply. This would increase inflation. The process of halting such acceleration in inflation is

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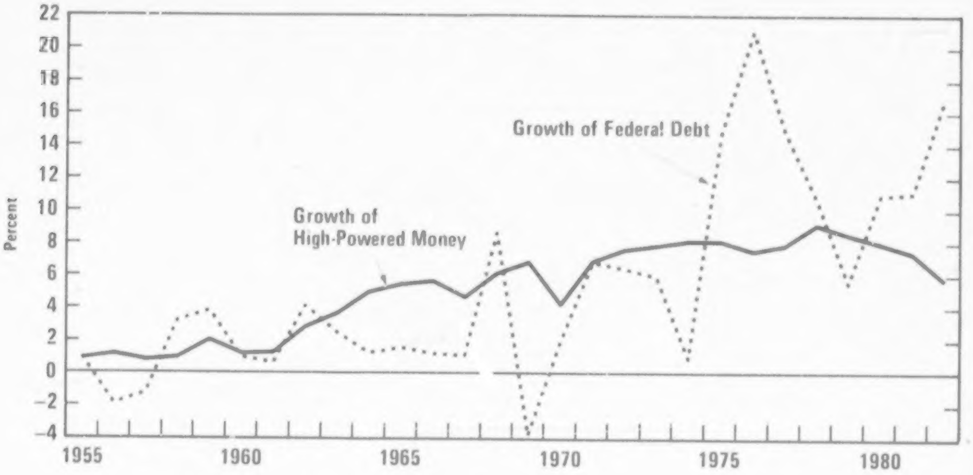
9/ While housing and consumer durables also contribute to living standards, favorable treatment of such expenditures in U.S. tax laws may imply that additional spending, especially on high-income housing, may contribute less to consumer welfare than would additions to the stock of business capital.

Figure 21.

Monetization of the Debt



SOURCES. Federal Reserve Board. Congressional Budget Office.

NOTE: High-powered money is bank reserves plus currency held by the public. Federal debt is the publicly-held interest-bearing debt.

likely to involve increases in unemployment and real interest rates and reductions in output and investment, much as it has in the past. Thus, persistent monetization threatens the economy with the compounded problems of inflation and eventual economic contraction.

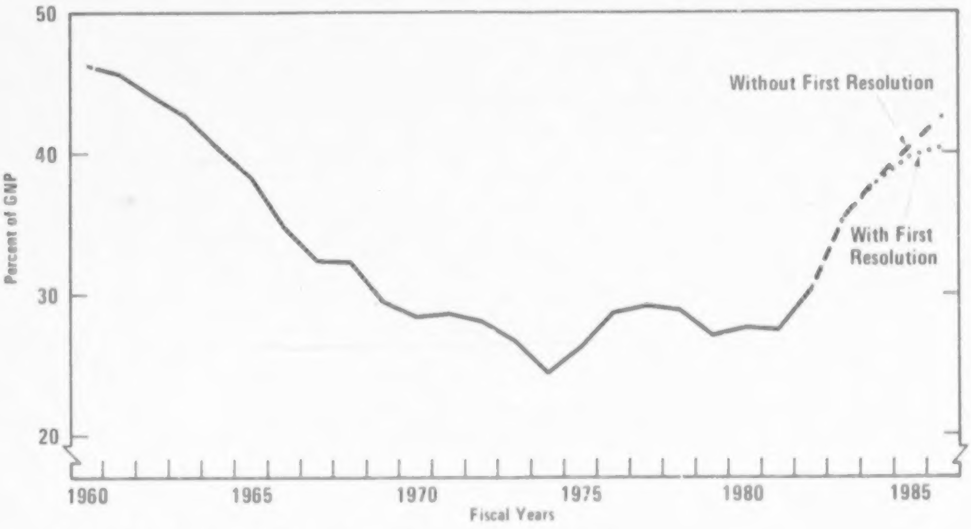
If financial markets react to large projected deficits by anticipating that they will be monetized, longer-term nominal interest rates may rise to reflect the expected inflation. There has been little recent evidence of monetization, however. As Figure 21 shows, the growth of "high-powered" money—that manipulated directly by the central bank—has slowed sharply since 1978, while the publicly-held debt has grown strongly.

How Much Deficit Reduction Is Enough?

Ultimately, the economic problem created by large deficits is that the federal debt may grow faster than the economy's capacity to absorb it. For this reason, many analysts argue that a compelling quantitative criterion or target for deficit reductions is that they should overcome the recent tendency for the debt to grow faster than the trend rate of growth in GNP.

Figure 22.

Publicly Held Federal Debt as a Percent of Gross National Product



SOURCE: Congressional Budget Office.

As Figure 22 shows, the ratio of the publicly-held federal debt to GNP has grown significantly since 1981, and is projected to continue growing strongly if deficit-reducing measures such as those in the First Concurrent Resolution are not implemented. With such measures, however, this growth should slow significantly by 1986. 10/ The First Resolution, then, would accomplish an important change in the budget outlook. 11/

10/ CBO's calculations of the growth tendency of the debt/GNP ratio over the distant future suggest that the ratio should stabilize under the policies contained in the First Resolution at a level close to that projected for 1986. For a discussion of the long-run analysis on which this estimate is based, see James Tobin, "Budget Deficits, Federal Debt, and Inflation in the Short and Long Runs," in Conference Board, Toward a Restructuring of Federal Budgeting (December 2, 1982).

11/ The President's February budget would have similar beneficial impacts, assuming that all contingent revenue increases took effect. See Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1984 (February 1983).

This change might not be permanent, however. The debt could again begin growing significantly faster than GNP if a slowdown in the economy's growth or an outright recession during the late 1980s was accompanied by an increase in real interest rates (see Box).

Possible Adverse Impacts of Deficit Reductions

As this discussion has shown, measures to reduce future deficits from the levels projected under current policy are essential to avoid long-term economic problems. However, deficit reduction measures would not be costless. Depending on the specific measures adopted and other economic conditions, there might be effects both on aggregate demand (temporarily) and on economic incentives affecting long-run growth.

Deficit-reducing measures would directly reduce the incomes of taxpayers, government workers, recipients of transfers, and others. As a result, businesses might reduce investment, anticipating reductions in their markets. If not offset by other factors, these developments might temporarily weaken GNP. There is also, however, one way in which spending cuts and tax increases may work to strengthen the economy in the short run if the measures are put into effect after a delay. They may reduce current long-term rates because of their expected impacts on future inflation and short-term interest rates. This decline in current long-term rates may stimulate growth in housing and business investment, and, if the growth is not offset by other factors, cause overall GNP to rise.

Quite apart from such potential complications in the short-run outlook, ill-chosen deficit-reducing measures may have adverse impacts on long-run growth that at least partially offset their intended effects. Measures to increase revenues may reduce the flows of savings, of risk-taking, or of labor supply if they have incentive-reducing impacts. Spending cuts may have similar perverse impacts, especially if they fall on programs of government investment that contribute to productivity growth in the long run.

Most analysts would argue that the favorable long-run impact of deficit cuts working through reductions in government borrowing and consequently in interest rates should be strong enough to outweigh their possible adverse impacts on incentives. Still, the best long-run policy would avoid affecting incentives by enacting deficit cuts that do as little as possible to raise marginal tax rates or reduce government investment.

CONCLUSION

The outlook for interest rates, monetary growth, and budget deficits has seldom been as complicated and uncertain as at present. Real interest rates have remained high, in part because of the anomalous behavior of the demand for money and the size of current and projected budget deficits. The future courses of both monetary and fiscal policy remain highly unsettled: the Federal Reserve faces conflicting pressures over how to react to recent strong money growth, and the budget is engulfed in controversy. The resulting uncertainty may be another reason that interest rates remain high.

Progress on either front—monetary or fiscal—will require progress on the other. Otherwise, efforts to reduce the growth of the federal debt may be offset by rising interest rates, while efforts by the Federal Reserve to hold down interest rates may be undermined by rising deficits.

WILL THE FEDERAL DEBT OUTRUN THE ECONOMY?

Some economists have observed that present policies are bringing the budget precariously close to the point at which larger and larger deficits are required merely to finance outlays for interest on the debt. Should this occur, it could spur strong growth in the federal debt and lead to financial stress as well as serious problems of crowding out and debt monetization unless holders of the debt help finance the debt increases by saving virtually all of the interest payments they receive.

Whether a given debt growth rate carries this threat depends on whether it exceeds the growth in the economy's capacity to absorb debt—that is, whether the debt grows faster than GNP. CBO estimates that although the debt may not grow faster than GNP indefinitely, there is a serious risk that a substantial amount of such growth could occur before finally coming to a stop. This risk will be significantly reduced if the Congress implements a program of deficit reductions like those entailed in either the First Concurrent Resolution or the President's February budget.

The growth tendency of the debt relative to GNP can be measured in terms of a few essential variables. The annual increase in the publicly held federal debt is roughly equal to the deficit (including off-budget borrowing). If the deficit were exactly equal to outlays for interest on the debt, the growth rate of the debt would be easy to measure—it would be the interest rate. In that situation, the growth rate of the debt would be less than that of GNP whenever the interest rate was less than GNP growth. Since the deficit tends to be larger than interest outlays, however, the growth rate of the debt is usually higher than the interest rate. As a result, the debt can grow faster than GNP even when the interest rate is below GNP growth. One way to stop the growth of the debt/GNP ratio is to make sure that the deficit is less than interest outlays. If the deficit is sufficiently smaller than interest outlays, the debt/GNP ratio will fall even if the interest rate exceeds the GNP growth rate.

Figure 22 shows CBO's current projections of the debt/GNP ratio. The ratio is projected to grow strongly if the First Concurrent Resolution is not implemented, despite the fact that GNP growth in CBO's projection exceeds the levels of interest rates. This debt growth occurs because projected deficits far exceed interest payments. Under the First Resolution, on the other hand, the growth of the ratio slows sharply by 1986.

CHAPTER IV. THE ECONOMIC OUTLOOK

This chapter presents the CBO short-run forecast for 1983 and 1984 and discusses the uncertainties in it. The chapter also gives medium-term economic projections for 1985-1986 and compares them with both the Administration's latest economic projections and those assumed by the Congress in the first budget resolution for 1984.

A broadbased economic recovery began in the first half of 1983 and is widely expected to continue into next year, with little change in the underlying rate of inflation. The revised CBO forecast shows real gross national product increasing approximately 5.8 percent in 1983 (fourth quarter to fourth quarter), and 4.3 percent in 1984. The civilian unemployment rate is forecast to decline to approximately 8.9 percent by the end of 1983 and to 8.2 percent by late 1984. Prices, as measured by the GNP deflator, are forecast to rise approximately 4.6 percent during 1983 and 5.0 percent in 1984.

The projected upswing is somewhat more rapid than CBO forecast in February, but still below average for the early phases of postwar recoveries. Restrictive credit conditions are expected to contribute to its moderate pace, and the foreign sector is expected to be particularly weak. A major uncertainty in the forecast is the course of interest rates and credit conditions, which in turn significantly depend on the conduct of monetary and fiscal policies.

THE CBO ECONOMIC FORECAST

The CBO economic forecast is based on the following assumptions:

- It uses budget estimates that reflect the policies of the first concurrent resolution for 1984. Budget outlays are assumed to be $807 billion in fiscal year 1983 and $860 billion to $868 billion in 1984, depending on whether the Congress decides to spend a "reserve fund" for antirecession assistance. (The difference would not have a large effect on the overall economic picture.) Revenues are projected at $600 billion in 1983 and $677 billion in 1984, reflecting tax increases of $12 billion for 1984.

- In regard to monetary policy, money aggregates are assumed to grow within the target ranges set by the Federal Reserve.

However, if velocity growth deviates sharply from historical experience, CBO assumes that the Federal Reserve will adjust its money targets in an attempt to ensure moderate growth in nominal GNP.

- The price of crude oil is expected to be flat during the forecast period, implying a cost of approximately $29 per barrel through 1984.
- Food prices at retail are assumed to rise only about 2.8 percent this year, and to increase next year at about the same rate as consumer prices in general.

Given these assumptions, the CBO forecast shown in Table 13 may be summarized by using midpoints of the forecast ranges, as follows:

- Real GNP is forecast to increase about 5.8 percent in 1983, on a fourth-quarter-to-fourth-quarter basis, and 4.3 percent in 1984.
- The civilian unemployment rate is forecast to average 9.7 percent in calendar year 1983 and 8.4 percent in 1984.
- Prices, as measured by the GNP implicit price deflator, are forecast to rise about 4.6 percent from the fourth quarter of 1982 to the fourth quarter of 1983 and 5.0 percent in 1984.
- Short-term interest rates, as measured by the three-month Treasury bill rate, are projected to average 8.8 percent in 1983 and 8.6 percent in 1984.

The Anatomy of Continued Recovery

On balance, conditions are favorable for continued moderate recovery during the forecast period, although there are substantial uncertainties. Growth in demand is expected to be quite strong, for several reasons: the almost unprecedented fiscal stimulus; an easing of credit conditions compared with the first half of 1982; and large pent-up demands for housing, autos, and other consumer durable goods. However, high real interest rates are expected to keep the pace of growth somewhat below average for the first two years of a recovery.

The specific sectors accounting for growth are expected to change during the course of the recovery. Earlier this year, the recovery was propelled by a dramatic increase in residential construction, a substantial slowing of inventory drawdown by business, and (in the second quarter) large

TABLE 13. THE CBO FORECAST FOR 1983 AND 1984

	Actual		Forecast	
	1981	1982	1983	1984
	Fourth Quarter to Fourth Quarter (percent change)			
Nominal GNP	10.8	2.6	8.6 to 12.6	7.5 to 11.5
Real GNP	2.0	-1.7	4.8 to 6.8	3.3 to 5.3
GNP Implicit Price Deflator	8.7	4.4	3.6 to 5.6	4.0 to 6.0
Consumer Price Index				
Urban consumers a/	9.6	4.5	2.2 to 4.2	3.7 to 5.7
Urban wage and clerical workers	9.4	4.4	2.4 to 4.4	3.7 to 5.7
	Calendar Year Average (percent)			
Civilian Unemployment Rate	7.6	9.7	9.2 to 10.2	7.9 to 8.9
3-Month Treasury Bill Rate	14.0	10.6	7.8 to 9.8	7.6 to 9.6

a/ Reflects shift to new concept in 1983, based on the rental equivalent measure for the current housing component. The CPI-W index is scheduled to be based on this new measure in 1985.

increases in consumer spending on durable goods. The contribution from housing and inventories may diminish, but households should continue to be in a very good position to spend. Their real disposable incomes are up sharply, because of the third phase of the tax cut that took effect in July, rising employment, and the moderate pace of price increases. Moreover, household net worth has also increased sharply. Correspondingly, measures of consumer confidence are very high as discussed in Chapter II of this report. In addition, business fixed investment is expected to strengthen in 1984—first equipment, followed by structures. The revival of business investment should be spurred by increases in sales, by an improved profit situation, and by a strong market for corporate equities; moreover, the net effect of the Accelerated Cost Recovery tax program, enacted in 1981, and the Tax Equity and Fiscal Responsibility Act, enacted in 1982, is substantially to reduce business taxes and raise after-tax returns on new business investment.

One major component of final demands, net exports, is expected to be off sharply during the forecast period. The sharp appreciation of the dollar has caused U.S. goods to become much less competitive in world markets, and foreign imports much more attractive. Since the effects of dollar appreciation on trade flows operate with lags, the weakness in net exports is expected to continue into next year.

The civilian unemployment rate is projected to decline gradually to about 8.9 percent late this year and 8.2 percent by late 1984. It will still be very high by historical standards. (Until the recent recession, the highest quarterly unemployment rate in the postwar period had been 8.9 percent in the second quarter of 1975.) Three factors tend to slow the decline in the unemployment rate during recoveries: a cyclical rebound in labor productivity (output per worker hour), increases in the average length of the workweek, and more rapid growth in the labor force in response to improved job prospects.

The Outlook for Prices and Interest Rates

The CBO forecast indicates only a small rise in inflation, notwithstanding two full years of recovery by the end of 1984. The GNP deflator is expected to rise approximately 4½ percent this year, about the same as last year. A slight acceleration is projected in 1984, primarily because some of the factors that have been holding down inflation are expected to be temporary. In particular, food and energy prices are not likely to have such a moderating effect on prices as in the recent past. The appreciation of the dollar in foreign exchange markets helped to hold down inflation temporarily, but many forecasters expect some weakness in the dollar next year that would tend to raise prices of imports and of import-competing goods. Finally, scheduled increases in payroll taxes seem likely to add about 0.3 percentage points to labor costs in 1984.

Prices are expected to behave moderately for three principal reasons. One is that no major supply price shocks seem likely. The world oil supply appears adequate to meet anticipated demand at or near current prices, and capacity is considerably above current levels of production. Very large stocks of grain should help to reduce the effects of recent adverse growing conditions.

A second reason for expecting relatively good price performance is the considerable slack in the economy. The unemployment rate will remain very high through 1984, with a moderating effect on wage increases. Indeed, it is difficult to point to any major categories of labor that seem likely to be in shortage during 1984. Capacity utilization rates, which were exceptionally low at the beginning of the recovery, are expected to rise only gradually during the forecast period. The availability of capacity, plus continued strong competition from abroad in some sectors, should help to slow price increases. 1/ A third reason for expecting moderate price performance is the assumption that the Federal Reserve will rein in money growth.

The CBO forecast shows interest rates drifting down slightly from current levels. The three-month Treasury bill rate, which is currently in the 9-1/4 to 9-3/4 percent range, is projected to average approximately 8½ percent next year. Several factors should help to moderate what otherwise would likely be a rising profile of interest rates associated with strongly rising GNP. One is a considerable improvement in business cash flow, which should help to slow private credit demands in 1984. The forecast also assumes that the deficit-reducing measures in the first budget resolution will be implemented, which should send an important signal to financial markets. Third, money velocity is expected to rebound somewhat for reasons other than higher interest rates, such as the end of the rapid decline in the inflation rate. This would help to allow the money aggregates to expand within their target ranges, without further tightening by the Federal Reserve. Finally, stable price performance should gradually contribute to lower interest rates, particularly long-term rates.

Uncertainties in the Outlook

The outlook for the current recovery is more uncertain than for the typical postwar recovery. Principal reasons include very high real interest rates, government borrowing that is projected to remain very high for a recovery period, and extremely weak net exports stemming from high U.S. interest rates and the strong dollar. 2/

1/ Most analysts also expect that rising productivity should reduce labor cost pressures—though much of the effect of the cyclical recovery in productivity can be expected to go into higher corporate profits rather than lower prices.

2/ These unusual characteristics for a recovery are not unrelated. For example, the high government deficits are being financed in part by inflows of foreign capital, leading to an appreciation of the dollar and the deterioration of net exports.

The single most important uncertainty in the forecast pertains to interest rates, which in turn are critically affected by monetary and fiscal policy. Interest rates could move substantially higher, or lower, than forecast. The combination of large government deficits and expanding private credit demands could produce higher interest rates than forecast. The optimism in the forecast is based on its assumption that the Congress will take steps to reduce the projected size of the deficits. If financial markets do not believe that such actions will be taken, or if such actions are not in fact realized, the result could be strong upward pressures on interest rates. Moreover, monetary policy is faced with the extremely difficult task of providing enough liquidity to sustain recovery, but not at the cost of reigniting inflation in 1985 and 1986. Large government deficits greatly complicate that task, as does the recent perplexing behavior of money velocity. Understandably, financial markets are uneasy in the current circumstances and tend to react strongly to each new piece of information about the speed of the recovery, inflation, and monetary and fiscal policies.

If interest rates were to move sharply higher, they could slow the recovery through several channels. Housing construction would be one of the sectors most adversely affected. A rise in interest rates would also dim consumer optimism, and with it the prospect for auto sales and other durable goods. Business fixed investment, particularly in structures, might also be weakened. Internationally, higher interest rates could exacerbate the debt problems of developing countries, weaken the economic recoveries that are beginning in other industrial countries, and reduce net exports from this country. 3/

Even if interest rates go no higher than projected in the forecast, they could slow the growth in demand more than forecast. There is much uncertainty about this relationship. Some analysts believe that in the early phase of recovery several major categories of spending, such as inventories, are not very sensitive to the level of real interest rates. But as the recovery matures, the impact of high real interest rates on interest-sensitive sectors, such as housing and business fixed investment, becomes much more severe.

To some extent, the uncertainties surrounding interest rates and economic growth may be symmetrical. The rapid growth in money during

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3/ The occurrence of higher interest rates than forecast would not inevitably mean weaker short run growth, since strong demand might be a contributing cause of the higher interest rates. However, the higher interest rates might still be a cause for concern because of their impact on the composition of output and on long-term growth. See the discussion of "crowding out" in Chapter III.

the past year could lead to a surge in economic growth, particularly if there is a snapback in velocity. Interest rates could turn out to be lower than forecast, or their effects on demand less pronounced. For one thing, the precise causes of the recent high interest rates are not well understood and they could prove to be a short-term historical aberration. For another, economists thus far in the current recovery have underestimated the strength of demand in the face of interest rates that seemed very high by historical standards.

Other significant uncertainties have to do with the foreign sector. Developing-country debt problems could lead to a sharp reduction in U.S. exports; or the large appreciation of the dollar could have a more devastating effect on U.S. trade flows than assumed in the forecast.

On the inflation front, the economy approaches a critical testing period. Some analysts question whether or not inflation is likely to remain stable in the 5 percent range during a period of sustained economic recovery at the projected rates. Here there are several imponderables. One is whether wage settlements will continue to be moderate as the recovery progresses. Another is the possible effect of the recent rapid growth in money on inflationary expectations. Still another is whether the Federal Reserve would attempt to rein in money growth at the price of substantially higher interest rates--given, for one thing, the precarious debt situation of several large developing countries such as Brazil and Mexico. If a typical cyclical recovery in velocity were to occur, continued rapid money growth would likely cause higher inflation.

THE ECONOMIC PROJECTIONS THROUGH 1986

While CBO does not forecast economic conditions beyond 1984, it develops noncyclical projections of the economy through 1986. The projections for 1985 and 1986 are based on assumptions about what appear to be attainable improvements in economic conditions. Among the principal assumptions used in making the projections are:

- Food prices (at retail) rise only slightly faster than prices in general.

- Crude oil prices are also projected to rise at about the same rate as prices in general, beginning in 1985.

- Productivity is assumed to trend upward at about 1½ percent a year, though actual productivity is expected to rise above this rate during the cyclical recovery.

TABLE 14. COMPARISON OF ECONOMIC OUTLOOKS (By calendar year)

Economic Variable	1983	1984	1985	1986
GNP (billions of current dollars)				
CBO revised	3,313	3,644	3,972	4,307
Administration revised	3,299	3,636	3,973	4,322
First budget resolution	3,292	3,621	3,948	4,269
CBO February 1983	3,266	3,580	3,903	4,221
Real GNP (percent change, year over year)				
CBO revised	3.1	5.0	4.0	3.5
Administration revised	3.1	5.2	4.2	4.0
First budget resolution	2.8	5.1	4.1	3.7
CBO February 1983	2.1	4.7	4.1	3.7
GNP Implicit Price Deflator (percent change, year over year)				
CBO revised	4.5	4.8	4.8	4.8
Administration revised	4.6	4.8	4.9	4.6
First budget resolution	4.7	4.6	4.7	4.3
CBO February 1983	4.6	4.7	4.7	4.3
CPI-U (percent change, year over year)				
CBO revised	3.2	4.7	4.7	4.7
Administration revised a/	3.1	4.4	4.6	4.6
First budget resolution	3.5	5.0	4.7	4.1
CBO February 1983	4.5	5.0	4.7	4.1
Unemployment Rate (percent, annual average)				
CBO revised	9.7	8.4	7.9	7.5
Administration revised b/	9.9	8.9	8.2	7.5
First budget resolution	10.1	9.3	8.5	7.9
CBO February 1983	10.6	9.8	9.0	8.4
3-Month Treasury Bill Rate (percent, annual average)				
CBO revised	8.8	8.6	7.7	7.4
Administration revised	8.6	8.5	7.8	7.2
First budget resolution	7.8	7.4	7.2	6.6
CBO February 1983	6.8	7.4	7.2	6.6

SOURCES: Conference report on the First Concurrent Resolution on the Budget—Fiscal Year 1984 (accompanying H. Con. Res. 91) reported June 21, 1983; Office of Management and Budget, Mid-Session Review of the 1984 Budget; CBO.

NOTE: The data for 1983 and 1984 represent midpoints of the CBO forecast ranges. The figures for 1985 and 1986 are projections based on assumptions.

a/ The Administration projects the CPI-W, rather than the CPI-U.

b/ The Administration projects the unemployment rate for the total labor force. The other projections in the table pertain to the civilian labor force.

- Real GNP is assumed to grow 4.0 percent in 1985 and 3.5 percent in 1986 (year-over-year).

These projections implicitly assume that the recovery lasts longer than many postwar recoveries, despite considerable uncertainty over monetary and fiscal policy. There is no guarantee that current tax and spending policies will prove consistent with the path of the economy as shown in the outyear projections. For example, the projections of interest rates may not be consistent with the size of the government deficits estimated on the basis of current budget policies. Similarly, with respect to monetary policy, growth in money aggregates is assumed to slow gradually, but the future course of velocity is highly uncertain. In addition to the level of nominal GNP, the relative shares of income accruing to different economic agents (e.g., individuals and corporations) vary over the business cycle. Between 1983 and 1986, the corporate profits share is expected to continue to rise from the depressed levels of the past year.

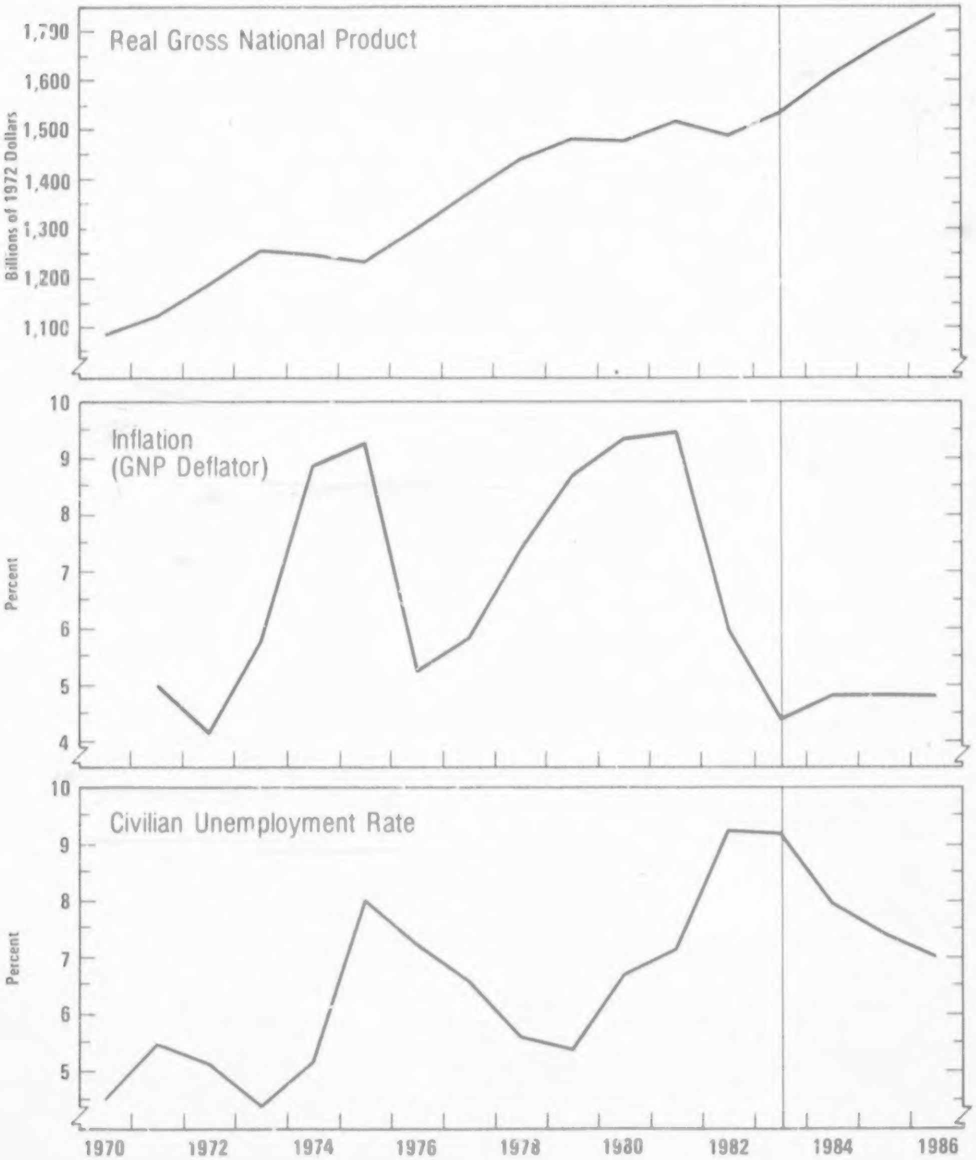
The economic projections, shown in Table 14 and Figure 23, can be summarized as follows:

- Nominal GNP growth is projected to decline gradually, from approximately 10 percent in 1984 to 8½ percent in 1986.
- Economic recovery continues at a moderate and gradually slowing pace.
- The civilian unemployment rate declines gradually to an average of 7.5 percent in 1986.
- Inflation is fairly flat after edging upward slightly from 1983 to 1984.
- The three-month Treasury bill rate declines by about 1½ percentage points between 1983 and 1986, implying a modest decline in real interest rates from current lofty levels.

Table 14 also compares CBO's revised economic outlook with three other sets of projections: those prepared by CBO last February, those used for the first budget resolution for 1984, and the Administration's economic assumptions contained in the Mid-Session Review of the 1984 budget. The revised forecast for 1983-1984 is somewhat more optimistic than the forecast CBO prepared last winter. In the new forecast, real growth is about one percentage point higher in 1983, and 0.3 percentage point higher in calendar 1984, while unemployment is roughly one percentage point lower in 1983 and 1½ percentage points lower in 1984. However, the forecast for the

Figure 23.

CBO Economic Projections



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

short-term Treasury bill rate is two percentage points higher for 1983 and about one percentage point higher for 1984, than seen earlier. Looking to the outyears, inflation is slightly higher in 1986 than projected earlier because economic slack has proved to be somewhat lower than expected.

The differences in the three sets of figures—the CBO revised projections, those used for the first concurrent resolution, and the revised Administration's—are quite small and well within the normal margin of error for such projections. Compared with the first resolution assumptions, the CBO revised outlook is somewhat lower for unemployment and higher for short-term interest rates—perhaps in part because the assumptions for the resolution were formulated several months earlier.

CHAPTER V. THE BUDGET OUTLOOK

After some delay and with considerable effort, the Congress adopted in late June a new budget resolution that revised the budget limits for fiscal year 1983 and set revenue and spending targets for 1984-1986. Under the policy assumptions of the resolution, CBO projects that the unified budget deficit would decline from $207 billion in 1983 to around $145 billion in 1986. About the same result would be obtained under the Administration's budget proposals, but the President has proposed more spending for defense programs and less for domestic programs than targeted by the Congressional budget plan.

While the Congress has made considerable progress in passing 1984 appropriation bills, action on the proposed revenue increases and spending reductions that are contained in the resolution reconciliation instructions has been delayed until September. With the budget policy differences between the Congress and the President unresolved, enactment of the deficit reduction measures assumed by the budget resolution is very uncertain. Without enactment of these measures, the unified budget deficit would remain close to $200 billion throughout the next three years. Even with enactment of these measures, however, the annual budget deficits are likely to be $12 to $19 billion higher than projected by the budget resolution, under CBO's latest economic and technical estimating assumptions. Furthermore, with the growing size of the federal debt and the consequent growing share of interest outlays in the budget, the deficit has become very sensitive to interest rates. If interest rates rise above projected levels as the result of increasing pressures on the credit markets, this would add further to the deficits.

CONGRESSIONAL BUDGET PLAN

The First Concurrent Resolution on the Budget for Fiscal Year 1984 that was adopted by the Congress on June 23, 1983, revised the Congressional budget totals for fiscal year 1983 and established new spending and revenue targets for fiscal years 1984, 1985, and 1986. The budget outlook under the policies of the first budget resolution as estimated by the CBO is summarized in Table 15. Under the Congressional budget plan, the unified budget deficit would decline from $207 billion in 1983 to about $145 billion in 1986, a reduction of 30 percent. Relative to GNP, the reduction in the budget deficit would be even greater, dropping from an estimated 6.4 percent in 1983 to about 3.5 percent in 1986.

TABLE 15. THE BUDGET OUTLOOK WITH POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1984
(By fiscal year, in billions of dollars)

	1982 Actual	1983 Estimate	CBO Projection		
			1984	1985	1986
Unified Budget					
Revenues	618	600	677	748	842
Outlays					
Including reserve fund a/	728	807	868	929	989
Excluding reserve fund	728	807	860	924	986
Deficit					
Including reserve fund a/	111	207	192	180	146
Excluding reserve fund	111	207	183	176	143
Off-Budget Outlays and Deficit	17	16	16	14	14
Total Deficit					
Including reserve fund a/	128	223	208	195	160
Excluding reserve fund	128	223	199	190	156

a/ Reserve fund for new initiatives in domestic programs provided for in the first budget resolution.

The improvement in the deficit outlook would result from considerably lower growth in federal expenditures and higher revenue growth than has been experienced lately. The growth in outlays during 1984-1986 would average 7 percent per year, compared to an average annual growth rate of close to 12 percent during the three preceding years 1981-1983. Outlays as a percentage of GNP would fall from an estimated 25.0 percent in 1983 to around 23.4 percent in 1986. Under the Congressional budget plan, revenues would grow by an average of 12 percent per year during the 1984-1986 period, compared to a 5.3 percent average annual growth between 1980 and 1983. Relative to GNP, revenues would rise from 18.6 percent in 1983 to 19.9 percent in 1986 (see Table 16).

TABLE 16. TRENDS IN REVENUES AND OUTLAYS a/
(By fiscal year, in percent)

	1983	1984	1985	1986
Revenues as a percent of GNP	18.6	19.0	19.2	19.9
Outlays as a percent of GNP				
With reserve fund b/	25.0	24.4	23.9	23.4
Without reserve fund	25.0	24.1	23.8	23.3
Deficit as a percent of GNP				
With reserve fund b/	6.4	5.4	4.6	3.5
Without reserve fund	6.4	5.1	4.5	3.4
Annual growth in revenues	-2.8	12.8	10.5	12.6
Annual growth in outlays				
With reserve fund b/	10.7	7.7	6.9	6.5
Without reserve fund	10.7	6.6	7.5	6.6
Reference: GNP ($ in billions)	3,230	3,562	3,890	4,222

a/ CBO estimates assuming the policies of the first budget resolution.

b/ Reserve fund for new initiatives in domestic programs.

Revenues

The projected rise in revenues during the next three years results mainly from the expected economic recovery. Under current tax laws, and CBO's latest economic assumptions, revenues are projected to grow as a percent of GNP. Between 1983 and 1986, CBO projects that revenues under current tax laws would rise from $600 billion to $796 billion, an annual average of 9.9 percent. The bulk of the projected growth in current law revenues between 1983 and 1986 is in income taxes and social insurance taxes and contributions. Social insurance taxes alone account for nearly one-half of the projected increase in revenues under current tax laws during the next three years. As shown in Table 17, social insurance taxes are projected to increase from $211 billion in 1983 to $300 billion in 1986, an increase of 42 percent over the period. This is due in part to the enactment earlier this year of the Social Security Amendments of 1983 which include future payroll tax increases as one means of solving the Social Security financing problem. Individual and corporate income taxes decline between

1982 and 1983, but then pick up in 1984. By 1986, individual income taxes are $65 billion higher, and corporate income tax receipts have more than doubled.

TABLE 17. CBO PROJECTIONS OF REVENUES BY SOURCE
(By fiscal year, in billions of dollars)

Major Source	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
Individual Income Taxes	298	288	293	324	353
Corporate Income Taxes	49	36	60	68	78
Social Insurance Taxes	201	211	243	272	300
Excise Taxes					
Windfall profit taxes	19	12	8	7	6
Other	17	23	29	31	27
Estate and Gift Taxes	8	6	6	6	5
Customs Duties	9	8	10	10	10
Miscellaneous Receipts					
Federal Reserve earnings	15	15	15	15	15
Other	1	1	1	1	1
Subtotal, Current Law	618	600	665	733	796
Resolution-Proposed Increases	---	---	12	15	46
Total	618	600	677	748	842

The budget resolution also assumes legislative action to increase revenues by $46 billion in 1986, and a total of $73 billion over the 1984-1986 period. These revenue increases were included in the resolution reconciliation instructions to the House Ways and Means Committee and the Senate Finance Committee, and constitute the major part of the deficit reduction policy changes proposed by the budget resolution (see Table 18).

Outlays

The projected deceleration of spending growth during 1984-1986 results primarily from spending reductions enacted in 1981 and 1982, and from projected declines in unemployment and inflation rates. It is also due in part to further policy changes assumed in the latest Congressional budget plan. These changes from CBO's baseline projections for spending are described in the Appendix.

The 1984 budget resolution includes reconciliation instructions to seven House committees and four Senate committees to report legislation to achieve outlay savings totaling $12 billion over the next three years. As shown in Table 4, about half of these savings would be achieved by holding federal employee pay raises to 4 percent annually during 1984-1986 and by changing the effective date for these pay raises from October to January. Approximately one-quarter of the reconciliation spending reductions are assumed to result from delaying the cost-of-living adjustments for federal employee retirement programs and veterans compensation benefits to January, consistent with a similar change made for Social Security benefits in the Social Security Amendments of 1983. The remaining one-quarter of spending reductions assumed for the reconciliation instructions are for savings in the Medicare program and the Small Business Administration's disaster loan program.

TABLE 18. BUDGET RESOLUTION RECONCILIATION INSTRUCTIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Revenue Increases	12.0	15.0	46.0	73.0
Spending Reductions a/				
Federal pay raises	-1.4	-2.0	-2.7	-6.0
COLA delays	-0.8	-1.0	-1.6	-3.4
Medicare savings	-0.4	-0.5	-0.8	-1.7
SBA disaster loans	-0.3	-0.5	-0.4	-1.2
Total	-2.8	-3.9	-5.5	-12.3
Deficit Reduction	-14.8	-18.9	-51.5	-85.3

a/ The reconciliation instructions do not specify reductions for specific programs, only amounts to be saved from programs under the jurisdiction of certain committees. The reductions shown here are those assumed for the resolution.

The 1984 budget resolution also provides for nearly $20 billion of spending increases during 1983-1986 for several new initiatives in domestic programs. These increases have been put into a "reserve fund," and would be released upon enactment of authorizing legislation. This reserve fund for domestic programs includes $5.4 billion in outlays for fiscal year 1983 and nearly $14 billion for 1984-1986 (see Table 19). The largest element in the reserve is for an economic recovery program to provide jobs for the long-term unemployed ($8 billion for 1983-1984). Other major elements include a program to provide health insurance benefits for unemployed workers and their families, a program to improve the nation's physical infrastructure, and the extension of federal supplemental compensation benefits for the long-term unemployed. Also included in the reserve are funds for increased benefits or expanded eligibility for food stamps, loan foreclosure relief to farmers, and emergency mortgage foreclosure relief to aid the unemployed. The CBO budget projections do not include any reserve fund outlays for 1983 because the authorizing legislation has not yet been enacted. The budget totals for 1984-1986 under the resolution are projected with and without the reserve fund initiatives, consistent with the conference report on the first budget resolution.

TABLE 19. BUDGET RESOLUTION RESERVE FOR NEW INITIATIVES IN DOMESTIC PROGRAMS (By fiscal year, outlays in billions of dollars)

Program	1983	1984	1985	1986
Economic Recovery Program	4.5	3.5	—	—
Health Insurance for the Unemployed	0.4	2.0	1.6	—
Physical Infrastructure Program	—	0.1	0.8	1.3
Extension of Supplemental Unemployment Benefits	—	1.5	—	—
Other New Initiatives	0.5	1.4	1.0	0.7
Total	5.4	8.5	3.4	2.0

Source: Conference Report on the First Concurrent Resolution on the Budget for Fiscal Year 1984 (H. Con. Res. 91).

Almost half of the projected spending increase under the policies of the budget resolution for 1984-1986 is for national defense programs. The resolution provides for 5 percent real growth in budget authority for national defense in each of the fiscal years 1984-1986. As shown in Table 20, outlays for national defense under the resolution targets are projected to rise from $213 billion in 1983 to $296 billion in 1986, an increase of $83 billion or nearly 40 percent.

TABLE 20. CBO PROJECTIONS OF OUTLAYS BY MAJOR SPENDING CATEGORIES (By fiscal year, in billions of dollars)

Major Spending Categories	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
National Defense	187	213	239	266	296
Entitlements and other Mandatory Spending	344	391	389	413	440
Nondefense Discretionary Spending	137	145	158	162	165
Reserve for New Initiatives	—	—	9	3	2
Net Interest	85	89	106	117	126
Offsetting Receipts	-24	-31	-32	-34	-40
Total Budget Outlays with Reserve	728	807	868	929	989
Total Budget Outlays without Reserve	728	807	860	924	986
Off-Budget Federal Entities	17	16	16	14	14
Total Outlays with Reserve	746	823	885	943	1,002
Total Outlays w/o Reserve	746	823	876	938	999

Another major source of outlay growth during the next three years is entitlements and other mandatory spending. These programs include Social Security, Medicare and Medicaid, unemployment benefits, and federal civilian employee retirement benefits; they account for about one-quarter of the projected growth in outlays during 1984-1986. By 1986, outlays for entitlements and other mandatory spending programs are projected to reach $440 billion, an increase of $49 billion or 13 percent from the 1983 level of $391 billion.

A third major source of outlay growth is net interest payments. These are projected to rise from $89 billion in 1983 to $126 billion in 1986, an increase of $37 billion or more than 40 percent. The share of the budget allocated to net interest costs would rise from 11 percent in 1983 to 13 percent by 1986. The projected rise in net interest outlays results mainly from growing federal debt levels. Under CBO's projections, the level of federal debt is projected to rise from $1.4 trillion at the end of fiscal year 1983 to $2.1 trillion by the end of 1986 (see Table 21.)

TABLE 21. BUDGET FINANCING AND DEBT OUTSTANDING a/
(By fiscal year, in billions of dollars)

	1982 Actual	1983 Estimate	CBO Projections 1984	1985	1986
Budget Financing					
Unified budget deficit	111	207	192	180	146
Off-budget deficit	17	16	16	14	14
Total	128	223	208	195	160
Means of financing other than borrowing from the public	-7	-10	*	-1	-1
Borrowing from the public	135	213	208	194	159
Debt Outstanding, End of Year					
Held by government agencies	218	244	274	314	363
Held by the public	929	1,143	1,351	1,545	1,704
Total, gross federal debt	1,147	1,387	1,625	1,858	2,067
Debt Subject to Limit, End of Year					
Total debt subject to statutory debt limit	1,143	1,383	1,621	1,854	2,063

* Less than $500 million.

a/ Based on CBO's estimates of the budget under the policies of the 1984 budget resolution, including the reserve fund amounts for 1984-1986.

As a result of the very large projected debt levels for 1984-1986, the sensitivity of the budget estimates to interest rate assumptions has become quite large. Table 22 shows the estimated effects on the federal deficits for 1984-1986 of one-percentage-point higher interest rates for all government securities beginning in October 1983 than projected by CBO for this period. This calculation assumes for illustrative purposes that the change in interest rates is not associated with any other changes in the economic assumptions. It is unlikely, however, that a change in interest rates would occur without changes in other economic variables. If these changes were taken into account, the effects on budget deficits would differ from those shown here.

Higher interest rates primarily affect the costs of new issues of government securities. Thus, the outlay effect of an interest rate change in the economic assumptions shown in Table 22 builds up over time as more and more securities are issued, including the refinancing of previous borrowing. The direct effect of the higher rates would be to add $19 billion to the unified budget deficits for the three-year period. This reflects substantially higher costs of servicing the public debt, offset in part by slightly higher Federal Reserve System earnings returned to the Treasury. The indirect effect of having to finance these higher deficits would be to add another $3 billion.

TABLE 22. THE EFFECT ON BUDGET DEFICITS OF ONE-PERCENTAGE-POINT HIGHER INTEREST RATES (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Caused Directly by Higher Interest Rates	3	7	9	19
Caused by Resulting Increase in the Deficit	*	1	2	3
Total	3	8	11	22

* Less than $500 million.

CBO BUDGET REESTIMATES

The budget projections discussed in the previous section are the CBO estimates of the policies contained in the first budget resolution for fiscal year 1984. These projections incorporate CBO reestimates of the resolution targets to reflect the economic forecast and longer-run assumptions described in Chapter IV, Congressional action since the adoption of the resolution new technical information presented in the Administration's mid-session review of the 1984 budget, and actual tax collections and cash outlays through June. The effects of the CBO reestimates of the budget resolution are to lower slightly the resolution unified budget deficit (including the reserve fund) for fiscal year 1983, and to raise the resolution deficits for 1984-1986 by $12 to $19 billion (see Table 23).

TABLE 23. CBO REESTIMATES OF THE FIRST BUDGET RESOLUTION a/ (By fiscal year, in billions of dollars)

	1983	1984	1985	1986
CBO Economic Assumptions				
Revenues	*	2	3	12
Outlays	-1	6	11	16
Deficit	-1	4	8	4
Congressional Action				
Revenues	*	-2	-2	-1
Outlays	-6	*	*	*
Deficit	-6	2	1	1
CBO Technical Reestimates				
Revenues	-4	-3	-4	-4
Outlays	*	4	6	6
Deficit	4	6	10	10
Total Reestimates				
Revenues	-4	-3	-2	7
Outlays	-6	10	17	22
Deficit	-2	12	19	16

* Less than $500 million.

a/ The CBO reestimates include the reserve fund for new domestic spending initiatives.

CBO projects slightly lower revenues for 1983-1985 than assumed for the budget resolution, and somewhat higher revenues for 1986. For the entire period, the cumulative CBO revenue estimates are almost identical to the resolution projections.

For outlays, CBO estimates are lower than the resolution for 1983 by $6 billion, but $10 to $22 billion higher for 1984-1986. Over the entire period, CBO's latest outlay estimates are $42 billion higher than specified by the budget resolution. Most of the higher outlay estimates (90 percent) can be attributed to higher interest rate assumptions.

Effect of Revised Economic Assumptions

As discussed in Chapter IV, the differences between the revised CBO economic assumptions and those used for the 1984 budget resolution for the most part are quite small. Compared with the resolution assumptions, CBO projects somewhat lower unemployment and higher inflation rates. The CBO projections for short-term interest rates are higher than the resolution by an average of about one percentage point throughout the 1983-1986 period, and the projections for longer-term rates are higher by about two percentage points.

Under CBO's latest economic assumptions, somewhat higher personal incomes would lead to more individual income and social insurance taxes under current law than estimated for the budget resolution. These are partially offset by lower windfall profit taxes due to lower oil price assumptions and, in some years, lower corporate income taxes due to lower taxable profits. The projected lower unemployment would result in somewhat lower unemployment compensation and related benefits. The higher revenues and lower unemployment benefit outlays, however, would be more than offset by higher debt service costs because of higher interest rates. The net effect of the revised CBO economic assumptions would be to increase the 1984 and 1986 budget deficits by $4 billion each, and the 1985 deficit by $7.7 billion, as shown in Table 24.

Effect of Congressional Action

Congressional action on the budget since the adoption of the 1984 resolution in June has not had much effect on the budget resolution targets. Action on the resolution's reconciliation instructions has been delayed until September. Action was completed on a 1983 supplemental appropriations bill and four 1984 regular appropriations bills. The Congress also repealed the tax withholding requirement on interest and dividend income that was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and passed a measure to put the financing of railroad retirement benefits on a sounder basis. Action was not completed, however, on any of the planned authorizations for new domestic initiatives that are provided for in the budget resolution reserve fund.

TABLE 24. CBO REESTIMATES OF THE 1984 BUDGET RESOLUTION ATTRIBUTABLE TO REVISED ECONOMIC ASSUMPTIONS
(By fiscal year, in billions of dollars)

	1983	1984	1985	1986
Revenues				
Individual income and social insurance taxes	3.2	6.2	5.0	9.6
Corporate profits taxes	-1.3	-3.6	-0.4	3.6
Other	-2.0	-0.4	-1.3	-1.6
Subtotal, revenues	-0.1	2.2	3.4	11.6
Outlays				
Interest costs				
Interest rates	0.4	9.9	12.5	15.6
Budget deficits	*	0.2	0.7	1.2
Unemployment compensation and related benefits	-1.0	-3.9	-2.5	-2.1
Social Security and other programs affected by inflation	*	0.2	0.4	1.1
Subtotal, outlays	-0.6	6.3	11.1	15.9
Deficit	-0.5	4.1	7.7	4.3

* Less than $50 million.

The effect of these Congressional actions, and the inaction to date on the reserve fund initiatives, is shown in Table 25. The repeal of withholding on interest and dividends, which was not assumed for the budget resolution, will lower revenues by about $2 billion per year during 1984-1986. This revenue loss will be partially offset from increased revenues resulting from the Railroad Retirement Act Amendments.

TABLE 25. CBO REESTIMATES OF THE 1984 BUDGET RESOLUTION ATTRIBUTABLE TO CONGRESSIONAL ACTION
(By fiscal year, in billions of dollars)

	1983	1984	1985	1986
Revenues				
Repeal of interest and dividends withholding	-0.2	-2.6	-2.4	-2.1
Railroad retirement amendments	—	0.3	0.7	0.9
Subtotal, revenues	-0.2	-2.3	-1.7	-1.2
Outlays				
Delayed action on reserve fund initiatives	-5.4	—	—	—
Supplemental appropriations bill and other action	-0.4	*	*	*
Debt service savings	-0.1	-0.5	-0.3	-0.2
Subtotal, outlays	-5.8	-0.5	-0.3	-0.1
Deficit	-5.6	1.8	1.4	1.2

* Less than $50 million.

Delayed action on the reserve fund initiatives will mean that there will be no outlays for these programs during fiscal year 1983. CBO has not reestimated the resolution amounts for these programs during 1984-1986. Final action on the 1983 supplemental appropriations bill also will result in somewhat lower outlays in 1983 than assumed for the budget resolution. The CBO estimates for fiscal year 1984 do not reflect completed action to date on the 1984 appropriation bills since any deviations from the resolution assumptions may be offset by subsequent action on other bills after the August recess. The net effect of Congressional action relative to the 1984 budget resolution, including savings in debt service costs, is to reduce the budget deficit for 1983 by over $5 billion, but to raise the deficits for 1984-1986 by a cumulative total of about $4 billion.

Effect of Technical Reestimates

Based on new information provided by the Administration's mid-session review of the 1984 budget, additional data on actual tax collections and spending for fiscal year 1983, and other sources, CBO has made a number of technical reestimates of Congressional budget resolution targets. These are summarized in Table 26. The effect of the CBO technical reestimates is to reduce the revenue estimates by about $4 billion per year for 1983-1986, and to raise projected outlays by increasing amounts—from $4 billion in 1984 to $6 billion in 1985 and in 1986. The net effect for the budget deficit is to add a total of $31 billion over the four-year period.

TABLE 26. CBO REESTIMATES OF THE 1984 BUDGET RESOLUTION ATTRIBUTABLE TO REVISED TECHNICAL ASSUMPTIONS (By fiscal year, in billions of dollars)

	1983	1984	1985	1986
Revenues	-3.9	-2.6	-4.0	-3.8
Outlays				
Defense programs	-1.8	-1.4	0.9	0.8
International programs	-1.5	-0.6	-0.5	-0.7
Agriculture	0.8	1.2	-0.1	-0.8
Mortgage credit and thrift insurance	1.7	0.6	0.6	0.5
Transportation	-0.8	0.2	0.2	-0.1
Health	-0.4	0.1	0.2	0.1
Income security	0.3	0.9	1.7	1.5
Social security	2.1	2.1	2.5	2.2
Net interest	*	-0.9	0.1	2.5
Other (net)	-0.2	1.5	0.7	0.3
Subtotal, outlays	0.2	3.7	6.2	6.3
Deficit	4.1	6.4	10.2	10.1

* Less than $50 million.

The technical reestimates of revenues reflect mainly updated estimates of revenue losses resulting from the liberalized saving incentives enacted as part of the Economic Recovery Tax Act of 1981 (ERTA). Actual contributions to individual retirement accounts (IRAs) and to Keogh plans have been running greater than assumed for the ERTA tax estimates. The CBO estimates are identical to those made by the Administration in its mid-session review.

The technical reestimates of outlays result from a number of different factors. Actual spending for defense programs in the current fiscal year through the first nine months has been less than anticipated. The relatively small shortfall (less than $2 billion) in defense outlays is expected to continue in 1984 and to be made up in part by higher spending in 1985-1986. Net lending by the Export-Import Bank has fallen off as a result of high interest rates and lower U. S. export activity. Receipts have also been greater than outlays in the foreign military sales trust fund. Farm price supports are estimated to be $1.2 billion higher in 1984 than assumed for the budget resolution as a result of reduced exports, a weaker wheat market, and greater net commodity loans.

Reestimates of spending for mortgage credit and thrift insurance activities result mainly from increased outlays by the Federal Deposit Insurance Corporation because of bank failures, higher net spending by the Federal Housing Administration fund because of higher than expected claims payments and lower levels of asset sales, and inaction on assumed 1983 asset sales in the housing program for the elderly and handicapped. Spending for various transportation programs and for Medicaid has been running lower to date in 1983 than assumed for the resolution.

The technical reestimates for income security programs in 1984-1986 reflect mainly revised average benefit levels for food stamps, increased SSI payments for disabled beneficiaries, higher estimates of families receiving AFDC benefits, and revised estimates for child support enforcement spending. The increased Social Security outlays of over $2 billion per year for 1983-1986 stem primarily from the updating of 1979 and 1980 earnings records. These updates had lagged behind schedule last year but an improved automated system is now operating. Most of the 1983 reestimate reflects the large retroactive payments resulting from these updates. Also contributing to the abnormal level of retroactive payments in 1983 are larger than anticipated payments for earnings records updated manually. In the 1984 to 1986 period, the updated earnings records result in higher average benefit payments. The relatively large net interest reestimate for 1986 is largely the increased debt service costs resulting from other technical reestimates in 1986 and prior years.

CBO Reestimates of the President's Budget

In addition to reestimating the 1984 budget resolution targets, CBO has reestimated the Administration's budget proposals as presented in its mid-session review of the budget. 1/ These reestimates, which use CBO's

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1/ Office of Management and Budget, Mid-Session Review of the 1984 Budget (July 25, 1983).

latest economic and technical assumptions, are relatively small in the aggregate. As shown in Table 27, CBO projects lower revenues in 1985 and 1986 under the Administration's proposals, largely because of differences in

TABLE 27. THE BUDGET OUTLOOK UNDER ADMINISTRATION POLICIES (By fiscal year, in billions of dollars)

	1983	1984	1985	1986
Revenues				
Administration estimate a/	600	668	748	862
CBO estimate	600	668	739	843
Outlays				
Administration estimate a/	810	848	918	991
CBO estimate	807	849	917	988
Deficit				
Administration estimate a/	210	180	170	129
CBO estimate	207	181	179	145
Sources of Differences in Estimates				
Revenues				
Economic assumptions	-1	-3	-8	-17
Congressional action	*	-2	-2	-1
Technical reestimates	1	5	1	-1
Outlays				
Economic assumptions	*	*	3	7
Congressional action	*	*	*	*
Technical reestimates	-3	*	-4	-10
Deficit				
Economic assumptions	1	3	11	24
Congressional action	*	2	2	1
Technical reestimates	-4	-4	-4	-10

* Less than $500 million.

a/ Office of Management and Budget, Mid-Session Review of the 1984 Budget (July 25, 1983).

economic assumptions about corporate profits and the Administration's proposed $5 per barrel contingency tax on oil. The CBO outlay estimates of the Administration's policies are quite close to those made by the Office of Management and Budget. CBO's upward reestimates in outlays resulting from small differences in economic assumptions are more than offset by downward technical reestimates.

The net effect of the CBO reestimates is a $3 billion lower deficit estimate for 1983, an $8 billion higher deficit in 1985 and a $16 billion higher deficit in 1986. The projected deficit for 1986 under the Administration's budget of $145 billion is about the same level as estimated by CBO under the policies of the 1984 budget resolution.

MAJOR UNCERTAINTIES IN THE BUDGET OUTLOOK

There are two major uncertainties affecting the budget outlook for 1984-1986. First, it is uncertain that the policy changes assumed in the 1984 budget resolution—particularly the assumptions regarding tax increases—will actually be implemented. Second, the economic assumptions underlying the CBO budget projections, particularly for inflation and interest rates, are uncertain.

Policy Issues

There appear to be substantial risks that the deficit reduction measures proposed by the Congressional budget resolution may not be realized. There is little or no disagreement over the general direction of fiscal policy for the next several years, but considerable disagreement over how budget deficit reductions should be achieved. As shown in Table 28 and portrayed graphically in Figure 24, the President has proposed greater spending reductions than embodied in the Congressional budget plan, and somewhat smaller tax increases, especially in 1984 and 1985. 2/

More striking than the differences in the size of the tax increases and net spending reductions are the differences in the composition of spending changes proposed by the President and the Congress. The President has proposed significantly higher levels of spending for defense programs during the next three years than would be provided for by the budget resolution, and much lower levels of spending for domestic programs. Under the President's 1984 budget proposals, outlays for national defense would exceed the resolution levels by $43 billion over the 1984-1986 period, but outlays

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2/ The policy changes proposed by the President and by the Congress are measured against the budget resolution baseline, which is described in Appendix A to this report.

TABLE 28. COMPARISON OF MAJOR BUDGET CHANGES PROPOSED BY THE CONGRESS AND THE PRESIDENT
(By fiscal year, in billions of dollars)

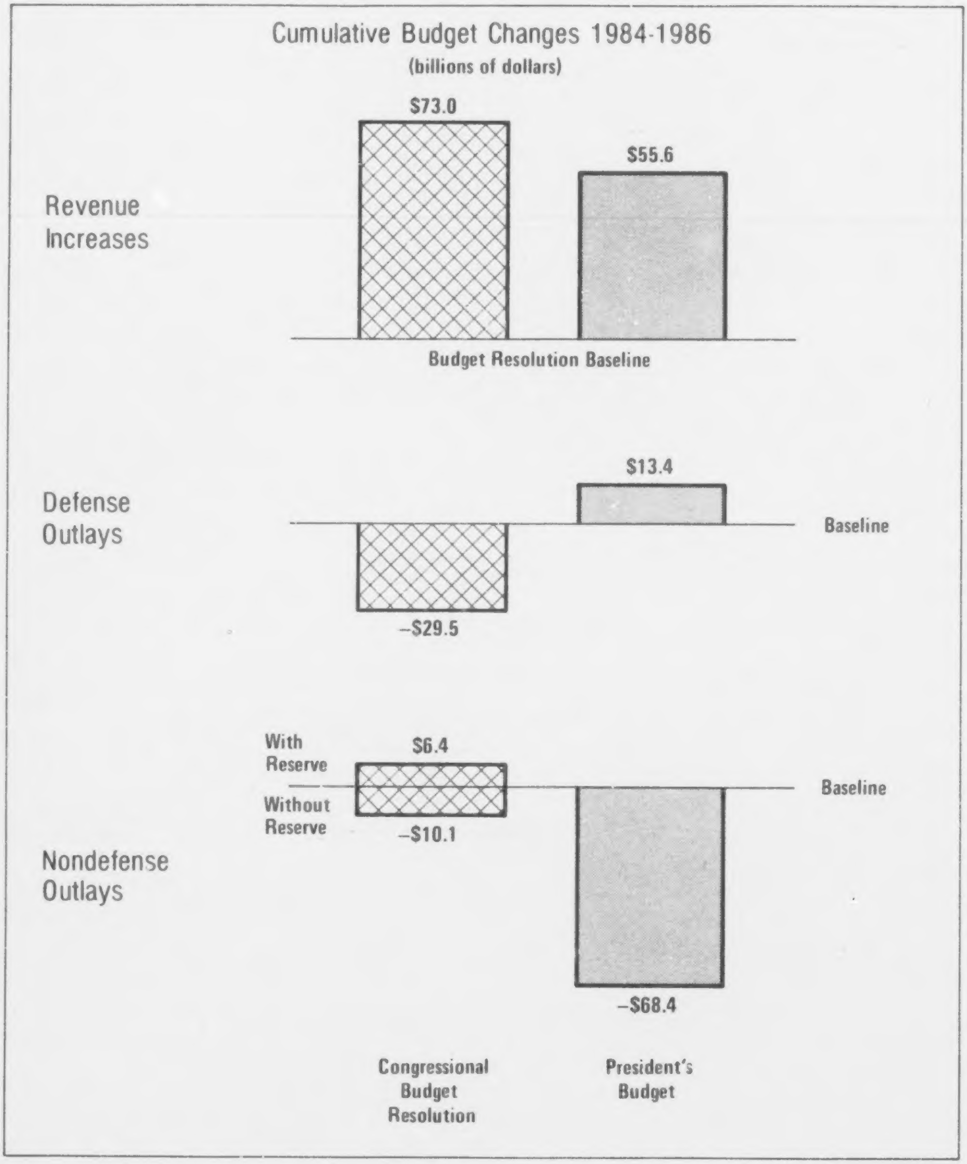
	1984	1985	1986	Cumulative 3-Year Total
Revenue Changes				
Budget Resolution	12.0	15.0	46.0	73.0
President's budget	3.1	5.8	46.7	55.6
Spending Changes				
National defense				
Budget resolution	-2.1	-12.4	-15.0	-29.5
President's budget	—	2.7	10.7	13.4
Nondefense spending				
Resolution with reserve	9.5	3.4	-6.5	6.4
Resolution w/o reserve	0.6	-1.0	-9.7	-10.1
President's budget	-12.3	-22.8	-33.3	-68.4
Total outlays				
Resolution with reserve	7.4	-9.0	-21.5	-23.1
Resolution w/o reserve	-1.5	-13.4	-24.7	-39.6
President's budget	-12.3	-20.1	-22.6	-55.0
Deficit Changes				
Resolution with reserve	-4.6	-24.1	-67.6	-96.3
Resolution w/o reserve	-13.5	-28.4	-70.8	-112.7
President's budget	-15.3	-26.0	-69.4	-110.7

NOTE: Budget changes are calculated from the 1984 budget resolution baseline (described in the Appendix) adjusted for CBO's latest economic and technical reestimates.

for nondefense programs would be lower by $58 billion to $75 billion. The President's 1984 budget does not include any provision for the new initiatives in domestic programs contemplated by the budget resolution in

Figure 24.

Major Budget Policy Differences



SOURCE: Congressional Budget Office.

the reserve fund. Furthermore, the President's budget proposes sharper cuts in Medicare and other domestic programs than provided for by the 1984 budget resolution. 3/

If no action is taken by the Congress on the proposed tax increases and spending reductions included in the resolution reconciliation instructions, the cumulative effect would be to add $85 billion to projected budget deficits for 1984-1986. These deficit additions would be only slightly offset by failure to enact the authorizations for several new initiatives for domestic spending covered by the resolution reserve fund. The net effect of not acting on the reconciliation instructions and the reserve fund authorizations, including the impact on net interest costs, would be to add $78 billion to the budget deficits for 1984-1986. Combining this impact with CBO's reestimates of the resolution presented in the previous section results in budget deficits that remain at the $200 billion level for the next three years (see Table 29).

Economic Assumptions

The second major uncertainty regarding the budget outlook is the uncertainty in the economic assumptions. As discussed in Chapter IV, the most uncertain components of CBO's latest economic forecast and longer-run assumptions are the future behavior of interest rates and inflation. A substantial tightening of credit conditions could lead to a reduction in growth in interest-sensitive sectors. The uncertainty in the outlook for inflation and for credit conditions stems mainly from the possibility of continuing large budget deficits of the magnitude shown in Table 14. Without the reduction in federal borrowing requirements provided in the budget resolution or the President's budget, the competition for available savings could lead to higher interest rates than assumed for this report. This in turn would lead to higher budget outlays to service the rapidly growing federal debt, and correspondingly higher deficits.

It is also possible that the economic recovery could be stronger than projected in this report. This would have a favorable impact on the budget, but by itself a stronger recovery would not replace the need to take further legislative actions to reduce federal spending and to increase revenues.

3/ For a discussion of the spending cuts proposed by the President, see Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 1984 (February 1983).

TABLE 29. IMPACT ON 1984 BUDGET RESOLUTION DEFICIT TARGETS FOR 1984-1986 OF NO ACTION ON RECONCILIATION INSTRUCTIONS AND RESERVE FUND AUTHORIZATIONS (By fiscal year, in billions of dollars)

	1984	1985	1986	Cumulative 3-Year Total
Budget Resolution Targets a/	179	161	131	471
CBO reestimates	12	19	16	47
No Action on Reconciliation Instructions	15	19	52	85
No Action on Reserve Fund Authorizations	-9	-3	-2	-14
Net Interest Cost Impact of No Action	*	2	5	7
Resulting Deficits	198	198	202	597

* Less than $500 million.

a/ Including the reserve fund for new initiatives in domestic programs.

APPENDIX

APPENDIX. BASELINE BUDGET PROJECTIONS

For the past two years, CBO baseline budget projections have served as the starting point in developing the Congressional budget resolutions. They have also been the baseline for computing the spending reductions and revenue increases to be achieved in the budget reconciliation process. The baseline consistent with the First Concurrent Resolution on the Budget for Fiscal Year 1984 differs in certain respects from the baseline projections published by CBO in February. [1] This appendix describes those differences. It also describes the policy differences between the budget resolution and the baseline and updates the baseline to CBO's latest economic and technical reestimates.

BUDGET RESOLUTION BASELINE

Between early February and the passage of the 1984 budget resolution in mid-June, the Congress enacted several major pieces of legislation. The Social Security Amendments of 1983 reduced outlays in 1984 and thereafter--primarily by delaying cost-of-living adjustments for Social Security cash benefits from July to January. Revenues were also increased by moving forward scheduled Social Security payroll tax increases, covering new federal workers and all employees of non-profit organizations, subjecting half of benefits above certain limits to income taxation, and raising the payroll tax rate on the self-employed. The Congress also enacted a supplemental appropriations bill designed to create additional jobs and help people adversely affected by the recession. The jobs bill raised budget outlays by $5 billion over the 1983-1986 period. The third major piece of legislation clarified the tax treatment of benefits under the Administration's payment-in-kind program for farmers. In total, this legislation, and the resulting changes in debt service costs, increased the deficit by $3 billion in 1983 but are expected to reduce it by $15 billion in 1986, as shown in Table A-1.

During the first half of the year, additional technical information also became available. This included the Administration's January budget (released after the CBO February projections report went to press), the April budget update, and data on actual spending and revenues for additional months of the current fiscal year. On the outlay side, the largest single reestimate was an increase of roughly $4 billion in farm price suppor outlays for fiscal year 1983. Technical factors reduced revenues slightly in 1983 and 1984 but increased them in 1985 and 1986. All in all, technical reestimates increased estimates of the deficit by about $6 billion in 1983 and 1984 and reduced them by $3 billion and $2 billion, respectively, in 1985 and 1986.

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[1] Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983).

Finally, economic developments during the first several months of 1983 suggested a need to update the economic assumptions underlying the CBO February baseline projections. The budget resolution conferees, therefore, adopted a new set of economic assumptions developed by the staffs of the House and Senate Budget Committees. These new assumptions reflected somewhat higher growth in real gross national product, lower unemployment, and higher interest rates than the earlier CBO forecast. Also, outlays for Social Security and related programs were reduced to reflect the actual increase in prices through the January-March quarter of 1983. These economic reestimates reduced projected deficits by $14 billion in 1984 and by $18 billion in 1985 and 1986. The total effect of these legislative, technical, and economic changes was to increase the baseline deficit in 1983 but to reduce it by increasing amounts in 1984, 1985, and 1986, as shown in Table A-1.

Differences Between the Budget Resolution and the Resolution Baseline

Table A-2 compares the fiscal year 1984 budget resolution with the budget resolution baseline by major spending category. Since the budget resolution and the baseline are predicated on the same technical and economic assumptions, all differences between the two are due to assumed differences in taxing or spending policy. In the case of net interest, the differences reflect the effects of the other policy differences on federal budget deficits and debt service costs.

The resolution assumes reductions in national defense spending growing from $2 billion in 1984 to $15 billion by 1986. Excluding the reserve, non-defense spending would differ little from baseline levels in 1984 and 1985 but be $8 billion below the baseline by 1986. Including the reserve, domestic spending would be about $10 billion higher than the baseline in 1984, $4 billion higher in 1985, and $4 billion lower in 1986.

The spending changes shown in Table A-2 are net changes and reflect both assumed increases and decreases in individual programs. In the entitlement category, for example, the budget resolution assumes reductions in cost-of-living adjustments for federal civilian retirement programs and in Medicare spending. These decreases are more than offset in 1984 and 1985, however, by assumed increases in spending for social services, railroad retirement, child nutrition, and other mandatory programs.

TABLE A-1. COMPARISON OF CBO FEBRUARY BASELINE AND BUDGET RESOLUTION BASELINE (By fiscal year, in billions of dollars) a/

	1983	1984	1985	1986
Outlays				
CBO February baseline	799.8	850.4	929.4	999.2
Enacted legislation				
Jobs bill	1.9	2.1	1.0	0.3
Social Security Amendments	0.7	-2.7	-3.2	-6.0
Debt service savings	0.1	*	-0.6	-1.5
Subtotal	2.7	-0.6	-2.8	-7.2
Technical reestimates	3.5	3.1	-1.5	1.0
Economic reestimates				
Actual cost-of-living adjustments	--	-0.8	-1.1	-1.2
Other economic changes	0.4	-1.3	-4.7	-5.7
Subtotal	0.4	-2.2	-5.8	-6.9
Budget resolution baseline	806.4	850.7	919.4	986.0
Revenues				
CBO February baseline	606.1	653.3	714.9	768.2
Enacted legislation				
Social Security Amendments	--	5.5	7.3	7.0
Agricultural Land Diversion Act	--	-0.6	-0.2	0.8
Subtotal	--	4.9	7.1	7.7
Technical reestimates	-3.0	-2.8	1.5	3.0
Economic reestimates	1.3	12.2	12.0	10.9
Budget resolution baseline	604.4	667.6	735.5	789.8
Deficit				
CBO February baseline	193.7	197.1	214.5	231.0
Enacted legislation	2.7	-5.5	-9.9	-14.9
Technical reestimates	6.5	5.9	-3.0	-2.0
Economic reestimates	-0.9	-14.4	-17.8	-17.8
Budget resolution baseline	202.0	183.1	183.9	196.2

* Less than $500 million.

a/ For February baseline see Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983).

TABLE A-2. COMPARISON OF FIRST BUDGET RESOLUTION AND BUDGET RESOLUTION BASELINE (By fiscal year, in billions of dollars)

	1983	1984	1985	1986
Budget Resolution, Including Reserve				
National Defense	214.3	240.0	265.3	295.0
Entitlements and Other Mandatory Spending	388.8	387.3	410.7	436.7
Nondefense Discretionary Spending	146.9	156.6	159.9	162.2
Civilian Agency Pay Raises	0.9	0.8	2.2	3.6
Reserve	5.4	8.5	3.4	2.0
Net Interest	88.4	98.0	104.5	107.2
Offsetting Receipts	-31.9	-32.3	-34.4	-40.0
Total outlays	812.8	858.9	911.6	966.6
Revenues	604.3	679.6	750.5	835.8
Deficit	208.6	179.3	161.1	130.8
Budget Resolution, Excluding Reserve				
National Defense	214.3	240.0	265.3	295.0
Entitlements and Other Mandatory Spending	388.8	387.3	410.7	436.7
Nondefense Discretionary Spending	146.9	156.6	159.9	162.2
Civilian Agency Pay Raises	0.9	0.8	2.2	3.6
Net Interest	88.3	97.1	103.1	105.5
Offsetting Receipts	-31.9	-32.3	-34.4	-40.0
Total outlays	807.4	849.5	906.8	963.0
Revenues	604.3	679.6	750.5	835.8
Deficit	203.1	169.9	156.2	127.2
Budget Resolution Baseline				
National Defense	214.3	242.1	277.7	310.0
Entitlements and Other Mandatory Spending	388.9	386.8	410.3	437.9
Nondefense Discretionary Spending	145.9	154.3	157.4	162.2
Civilian Agency Pay Raises	0.9	1.7	3.4	5.2
Net Interest	88.3	97.4	104.9	110.7
Offsetting Receipts	-31.9	-31.6	-34.3	-39.0
Total outlays	806.4	850.7	919.4	986.0
Revenues	604.4	667.6	735.5	789.8
Deficit	202.0	183.1	183.9	196.2

(Continued)

TABLE A-2. (Continued)

	1983	1984	1985	1986
Policy Differences, Including Reserve				
National Defense	—	-2.1	-12.4	-15.0
Entitlements and Other Mandatory Spending	*	0.4	0.4	-1.2
Nondefense Discretionary Spending	1.0	2.3	2.4	*
Civilian Agency Pay Raises	—	-0.9	-1.2	-1.6
Reserve	5.4	8.5	3.4	2.0
Net Interest	0.1	0.6	-0.4	-3.5
Offsetting Receipts	—	-0.6	-0.1	-0.1
Total outlays	6.5	8.2	-7.8	-19.4
Revenues	-0.1	12.0	15.0	46.0
Deficit	6.6	-3.8	-22.8	-65.4
Policy Differences, Excluding Reserve				
National Defense	—	-2.1	-12.4	-15.0
Entitlements and Other Mandatory Spending	*	0.4	0.4	-1.2
Nondefense Discretionary Spending	1.0	2.3	2.4	*
Civilian Agency Pay Raises	—	-0.9	-1.2	-1.6
Net Interest	—	-0.3	-1.8	-5.2
Offsetting Receipts	—	-0.6	-0.1	-0.1
Total outlays	1.0	-1.2	-12.6	-23.1
Revenues	-0.1	12.0	15.0	46.0
Deficit	1.2	-13.2	-27.6	-69.1

* Less than $500 million.

UPDATED BASELINE PROJECTIONS

Chapter V described the reestimates that CBO has made to the budget resolution projections on account of recent legislative, economic, and technical developments. Table A-3 provides comparable baseline projections, derived by applying the same reestimates to the budget resolution baseline. These projections show what would happen if the policies of the budget resolution are not implemented. They indicate that, if current spending and taxing policies were to continue unchanged through 1986, budget deficits would continue to be close to the $207 billion figure CBO estimates for 1983.

TABLE A-3. BASELINE BUDGET PROJECTIONS UPDATED FOR CBO TECHNICAL AND ECONOMIC REESTIMATES (By fiscal year, in billions of dollars)

	1983	1984	1985	1986
National Defense	213	241	279	311
Entitlements and Other Mandatory Spending	391	388	413	441
Nondefense Discretionary Spending	145	155	158	161
Civilian Agency Pay Raises	—	2	3	5
Net Interest	89	106	119	132
Offsetting Receipts	-31	-31	-34	-40
Total outlays	807	861	938	1,010
Revenues	600	665	733	796
Deficit	207	196	205	214